

***United States Court of Appeals
for the Second Circuit***



**APPELLANT'S
REPLY BRIEF**

77-7104

To be argued by
SIDNEY B. SILVERMAN

United States Court of Appeals

FOR THE SECOND CIRCUIT

Docket 77-7104

DAVID E. ROLF,

Plaintiff-Appellant
Cross-Appellee,

against

BLYTH, EASTMAN DILLON & Co., INC. AND MICHAEL STOTT,

Defendants-Appellees
Cross-Appellants,

and

AKIYOSHI YAMADA,

Defendant.

REPLY BRIEF OF PLAINTIFF AS APPELLANT AND ANSWERING BRIEF OF PLAINTIFF AS CROSS-APPELLEE

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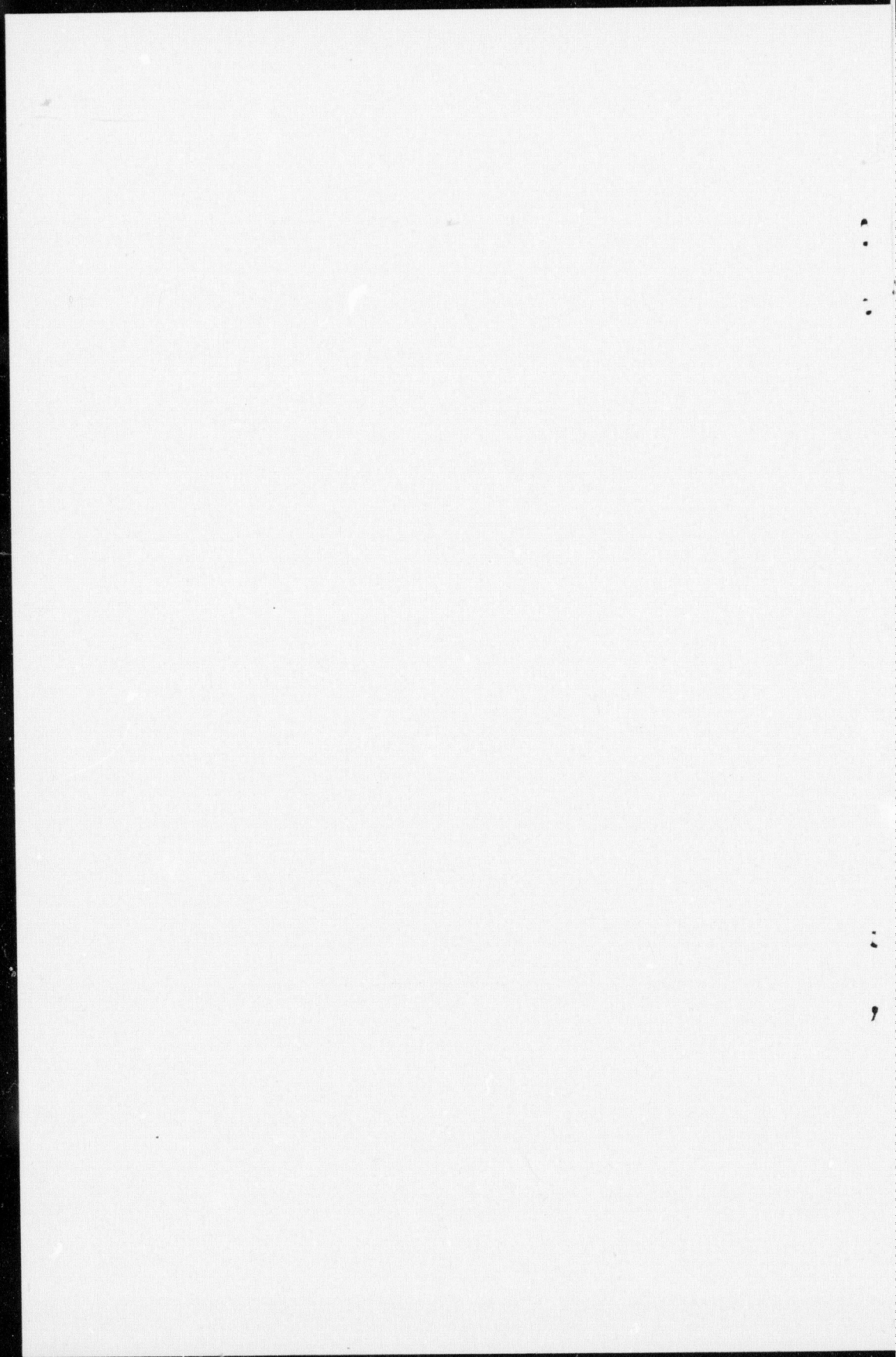
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Preliminary Statement

The defendants' strategy is one of camouflage. Thus, in their brief, defendants seek to obscure the course of events which resulted in the plaintiff's loss. However, despite the defendants' attempt to screen it, the course is not a difficult one to follow. Armed with the testimony adduced at the trial and a record of the purchases and sales which were

made for plaintiff, one can easily reconstruct the manner in which defendants defrauded Dr. Rolf, and caused him to incur losses of approximately \$1.3 million. By examining the dates of purchases and sales, the amounts of money involved, and other relevant factors as revealed in the testimony, one can discern the development of a basic pattern: the use of the plaintiff's account by two fiduciaries for their own purposes.

Defendants' brief indicates that they see this pattern clearly. By omitting relevant factors, by separating the transactions from their circumstances and by dividing them into smaller and smaller categories, defendants apparently hope to conceal what actually took place.*

Plaintiff recognizes the defendants' over-all scheme to isolate various transactions and treat them as unrelated events. Nevertheless, because defendants' claims, however presented, are so firmly based on untruths or distortions of facts, plaintiff will deal with such claims in the format in which they have been presented, the more convincingly to dismiss them. However, before undertaking to do so, plaintiff sets forth two central truths which must be placed before the Court, both of which have been omitted from the defendants' brief:

1. Each and every transaction made on plaintiff's behalf during the complaint period bears some relation to every other transaction made during that period. All are part of a two year course of action, all components of a continuing fraud. There are not, as defendants might suggest, 38 different frauds here, or even four. For two years, defendants used plaintiff's account for their own ends, and since each transaction effected for plaintiff by defendants bears some relation to their other activities,

* It is for this reason that, for example, defendants' charts contain no dates.

each transaction must be considered in the context of the entire record.*

2. Stott was the central figure in the events which took place. From the start, he and Yamada worked in concert, and their exploitation of the plaintiff's account was designed to further the personal aims of each.

ARGUMENT

Standard of Appellate Review of the Trial Court's Findings of Fact.

Rule 52(a) of the Federal Rules of Civil Procedure provides, in pertinent part, with respect to all actions tried without a jury; "Findings of fact shall not be set aside unless clearly erroneous, and due regard shall be given to the opportunity of the trial court to judge the credibility of the witnesses." On appeal, the appellee is entitled to the benefit of all reasonable inferences and to have the evidence viewed in a light most favorable to him. If when so viewed, there is substantial evidence to sustain the judgment, it cannot be reversed. *Stacher v. United States*.**

In *Zenith Radio Corporation v. Hazeltine Research Inc.*,*** the Supreme Court stated:

"The authority of an appellate court, when reviewing the findings of a judge as well as those of a jury, is

* Thus, for example, although plaintiff might not claim damages as a result of a successful manipulation from which he actually profited, when such a manipulation was undertaken to supply plaintiff with small, quick profits in order to silence his complaints about the large losses in his account and permit the further use by the defendants of that account, then plaintiff contends, the manipulation constitutes a part of the over-all fraud perpetrated by defendants and cannot be ignored. Accordingly, defendants cannot justify their conduct by pointing to isolated transactions in which plaintiff made a profit, when such transactions, be they short-swing purchases or manipulations, facilitated other larger frauds.

** 258 F. 2d 112 (9th Cir. 1958).

*** 395 U.S. 100 (1969).

circumscribed by the deference it must give to decisions of the trier of the fact, who is usually in a superior position to appraise and weigh the evidence.”

Thus, whether the reviewing court might give the facts another construction and resolve ambiguities differently is irrelevant.* The question is not whether the reviewing court would have found otherwise, but whether the trial court could permissably have found as it did.**

In matters of credibility, motive and intent, the trial court's findings are treated with particular deference. The Supreme Court stated in *United States v. Yellow Cab Co.*:*** “Findings as to the design, motive and intent with which men act depend peculiarly upon the credit given to the witnesses by those who see and hear them.” The Second Circuit noted in *Hedger v. Reynolds*:****

“The burden of an appellant who seeks to reverse a judgment for error in fact, to show that essential findings are clearly erroneous is, indeed, a heavy one when, as in this instance, decision must turn largely upon the credibility of witnesses the trial judge saw and heard testify.”

Judge Learned Hand stated in the landmark case of *United States v. Aluminum Co. of America*:*****

“[W]hatever may be said in favor of reversing a trial judge's findings when he has not seen the witnesses, when he has, and in so far as his findings depend upon whether they spoke the truth, the accepted rule is that they ‘must be treated as unassailable’.”

Judge Sanborn of the Eighth Circuit, many years before, summed up the relevant rule regarding non-jury trials

* *United States v. National Association of Real Estate Boards*. 339 U.S. 485, 495-496 (1950).

** *Japhe v. A.T.O. Inc.*, 481 F. 2d 366 (5th Cir. 1973).

*** 338 U.S. 338, 341 (1949).

**** 216 F. 2d 202 (2d Cir. 1954).

***** 148 F. 2d 416, 433 (2d Cir. 1945).

in the case of *Pendergrass v. New York Life Insurance Co.*,* when that court found:

“no warrant for the belief that we can retry doubtful issues of fact upon a cold record, and substitute our judgment for that of the trial court with respect to such issues...”

PART ONE

Point I

Stott Is Responsible for \$427,000 Lost by The Liquidation of Plaintiff's Account

Defendants make two claims concerning the liquidation of plaintiff's account: 1) that Stott is not responsible for any losses which might have occurred and 2) that the losses really did not amount to \$427,000. As shown below, both statements are demonstrably false.

A. Stott Was Intimately Involved In the Decision To Liquidate Plaintiff's Portfolio

Defendants attempt to absolve Stott from any responsibility for the liquidation of plaintiff's account by making two assertions: that Yamada did not discuss the liquidation with Stott, and that he did discuss it with plaintiff. Although the defendants further label these claims “undisputed” and “uncontradicted,”** both are untrue.

The evidence is clear that Yamada discussed the liquidation of plaintiff's account with Stott. The decision to sell was jointly made and Stott's influence can clearly be seen in the record of the sales. Yamada testified that not only did he consult Stott before liquidating, but that Stott was

* 181 F. 2d 136, 138 (8th Cir. 1950).

** Defs. br. p. 7.

eager to do so, provided the sales were made through BEDCO:

Q. "When you began to serve as Dr. Rolf's investment adviser, did you make any decisions as to the sale of securities then in his portfolio?"

A. "Yes."

Q. "Did you consult with anybody about your decisions?"

A. "Yes, sir."

Q. "With whom did you consult?"

A. "Mr. Stott."

Q. "What did the two of you decide?"

A. "We decided that a substantial part of the portfolio needed to be sold and the portfolio needed to be restructured. (JA-379-380)

* * *

A. "Mr. Stott was in favor of my liquidating a significant amount of the portfolio and he stated that he wanted the commission business from that." (JA-381)

The very page which defendants cite to prove that Yamada did not discuss the liquidation with Stott, proves instead, the very opposite:

Q. "Did you discuss with Mr. Stott the selling of any one of these securities?"

A. "I discussed with Mr. Stott the selling of securities and he wanted to make sure it was done through Eastman Dillon."

Q. "When did you discuss with Mr. Stott the selling of these securities, any one of them?"

A. "I can't recall as to the specific stock in general, but I would guess when I started selling them, which would be in May of '70.* [sic]

* Yamada clearly meant May, 1969.

Q. "Did you discuss with Mr. Stott, or he with you, the wisdom of selling any of these securities?"

A. "He thought it was a good idea too." (JA-437).

The "undisputed" fact is that Yamada made the decision to liquidate the securities in conjunction with Stott. He consulted Stott before he made the decision, and Stott approved. Therefore, Stott is equally responsible for the losses occasioned by the liquidation.

B. Plaintiff Did Not Approve The Liquidation Of His Account

Defendants' second assertion that Dr. Rolf knew from his first discussion with Yamada that Yamada was "going to sell the Stirling acquired inventory," is equally false. The testimony, as given by both plaintiff and Yamada, is again quite clear. Plaintiff testified:

"Q. Was there any discussion between you and Mr. Yamada at your last conversation with respect to the liquidation of your security portfolio as that existed as of April 30, 1969?"

"A. He didn't say he was going to liquidate. He said he was going to manage the account. He didn't make any specific remarks about he was going to liquidate or not liquidate." (JA-196).

Yamada, in his testimony, supported the doctor:

"Q. Was there a discussion of the liquidation of all of these securities at that meeting?"

"A. No, sir, there was not a discussion of liquidating the entire portfolio." (JA-436).

Defendants not only ignore this testimony, but are guilty of a glaring deception when they cite other testimony of Yamada's in such a way as to suggest that it encompassed the entire liquidation. Thus, they refer to a discussion of the "sale of this inventory," "the disposi-

tion of those securities" and "this liquidation." In fact, however, the testimony of Yamada cited in defendants' brief* refers only to a discussion of the sale of Levin-Townsend, National General and "a couple of other conglomerate stocks." (JA-435). This testimony does not refer to a liquidation but, rather, to the sale of only four securities, and its misrepresentation constitutes another example of defendants' attempt to distort the record.

Still, it is instructive to look more closely at this conversation cited by defendants, for here we have the most concrete exposition of the "changes" plaintiff expected to be made in his account, i.e., the sale of a few conglomerates. Here is offered the only possible investment reason for the sale of a portion of the Stirling inventory. Yet the record shows that rather than the sale of a few stocks for investment purposes, the whole account was liquidated in a massive and hasty sale which was directed by defendants' own greedy ends.

Moreover, even though plaintiff was informed that Levin-Townsend, National General and a few conglomerates needed to be sold, when the account was actually liquidated, the stocks earlier listed by Yamada as conglomerates** were not the first to be sold. Instead, those securities which Yamada himself called "blue chips"*** were quickly ransacked. The first day of trading by the defendants, when \$126,564 worth of securities were sold to purchase Asamera at Stott's behest, the stocks disposed of were not Levin-Townsend or National General, but Penn Central, Raytheon and INA Corp. (DXUU, E-134). All three were rated "high quality" by plaintiff's expert,

* (JA-436, lines 3-9).

** (JA-432; JA-433) These include Loew's Theatre, Leasco Data Processing, Avnet, Glen Alden, International Industries, Levin-Townsend, National General and Teledyne.

*** (JA-434), General Electric, Anaconda, Raytheon, Pittston, Penn Central.

and two were rated "blue chips" by Yamada, himself. (Yamada XA, E-191; JA434). National General, which Yamada informed Rolf needed to be sold, was not finally disposed of until August, (DXUU, E-140) long after the blue chips were gone. Indeed, the Stott-Yamada stewardship was little more than a month old, before, with the exception of Anaconda, which was partially liquidated, the blue chips had all been sold. (DXUU, E-136). In contrast, after 2½ months, five of the eight conglomerates still remained in plaintiff's account. Thus, the record clearly demonstrates, the investment considerations outlined by Yamada to Dr. Rolf at their first meeting for the sale of some of his securities were totally ignored.

The decimation of plaintiff's "blue chips" was not random. The pattern of their sales parallels the pattern of Stott's purchases. Whenever Stott needed quick cash to make a purchase, he sold the most marketable securities, i.e., the "blue chips." The record reveals that it was Stott's influence, his insatiable desire for commissions, which caused plaintiff's high quality securities to be sold:

<u>Stott Purchase</u>		<u>Sale</u>
Asamera	5/12/-13	Penn Central, Raytheon, INA
Simplex	6/17	Raytheon
Reading & Bates	6/18	Pittson Co., Penn Central
Standard Oil Of N. J.	7/15	Anaconda, Int'l Industries

(DXUU, E-134, 136, 138).

When Dr. Rolf retained defendants Yamada and Stott to manage his account, plaintiff thought, as the Trial Court found, that he was obtaining a "Stirling-type" operation. Plaintiff, therefore, had no reason to believe that his blue chips would be hastily jettisoned and had every reason to expect that any decision to sell securities in his account would be made after a careful study of market conditions

and would be based upon factors relevant to each particular stock. The reason offered by Yamada to Dr. Rolf in support of the former's desire to sell some of the conglomerates seemed sensible to plaintiff. The "major play" in some of them "had already gone by and it was time to get rid of them." Had Yamada and Stott followed these limited plans outlined in that meeting and effected a slow and reasoned partial liquidation of plaintiff's portfolio, then defendants might perhaps justifiably blame "bear market" conditions for the losses incurred.

Instead, however, defendants ignored market conditions and used plaintiff's account for their own ends. Yamada testified that his interest in the account was buying power; (JA-381; JA-409) the record of his sales confirm this. During the first week of the Stott-Yamada stewardship, \$515,452.13 of securities were sold. (DXUU, E-134). Thus, over half a million dollars worth of stock was sold in one week. Those sales were made to raise funds for the purchase of Asamera and Monarch and thus, generate commissions for Stott and Lynch, Jones & Ryan, to whom Yamada was indebted. Again in July, Yamada disposed of \$491,674 worth of securities in one week in order to effect the Delanair purchase. (DXUU, E-138). These massive liquidations, \$1,007,126 in two weeks, were not made because of market factors, but because Yamada needed to raise cash and Stott was demanding commission business. (JA-380-381). A study of the record shows a continuing pattern of quick disposals of plaintiff's portfolio immediately followed by purchases of Stott securities. The timing of the sales depended not on market conditions, but on the demands of Stott:

Sales of Stirling Securities 5/12-5/13	-----	\$126,564
Purchase of Stott Recommendation		
(Asamera) 5/12-5/13	-----	126,587
Sales of Stirling Securities 6/10	-----	35,703

Purchase of Stott Recommendation (Simplex) 6/10 -----	34,360
Sales of Stirling Securities 6/18 -----	107,557
Purchase of Stott Recommendation (Reading & Bates) 6/19 -----	125,190
Sales of Stirling Securities 7/8 [due date 7/15] -----	72,027
Purchase of Stott Recommendation (Standard Oil of N.J.)-7/15-----	73,337
(DXUU, E-134, 136, 138)	

That Stott was deciding when to buy and sell is clearly indicated by this pattern of sales and purchases. The purchase of Standard Oil of New Jersey particularly emphasizes his involvement. Although it is initially puzzling that a \$73,337 purchase was made in the midst of the massive liquidation preceding the Delanair transaction, it is not so when one sees that \$72,027 was due that day from Stott's earlier sale. Stott's influence is similarly evident throughout the liquidation and it was Stott who most consistently ignored the guidelines set by plaintiff and Yamada.

Because the manner in which defendants liquidated plaintiff's portfolio bore no relation to market conditions, those conditions cannot be deemed responsible for the losses incurred. Stott and Yamada made the decision to liquidate plaintiff's account for their own purposes, and accordingly, they are responsible for the losses incurred.

C. Plaintiff's Losses Incurred By the Liquidation Aggregate \$427,000

Defendants challenge plaintiff's method of determining losses and attempt a feat of legerdemain, turning actual losses into supposed profits. Defendants deem plaintiff's method of computation a "fatal deficiency" and selectively choose certain securities in an effort to make it appear that plaintiff actually profited from the liquidation. Thus, de-

defendants assert that one must not look at the market value of the securities at the time Yamada and Stott took over the account, but at the cost of the securities, even if purchased years earlier.

Defendants argue that plaintiff's damage should be measured by cost, rather than market value. Defendants cite no authority for such a proposition. Plaintiff's portfolio of readily marketable securities had a net market value of \$1,423,000 at the start of the Stott-Yamada period. What plaintiff paid for such securities many years earlier has no relevance to the amount of loss sustained by plaintiff at the hands of Stott and Yamada during the period in which they managed his account. In determining the plaintiff's loss, there would appear to be no reason to give the defendants the benefit of market appreciation which occurred before the plaintiff's account was turned over to them. The defendants cite no authority for the proposition that cost, rather than market, should be used and their reasoning in support of such proposition is obviously faulty.

In a tort action (including fraud), in determining the proper measure of damages, the fair market value and not the original cost of the property damaged or destroyed is the starting point.* In cases involving the conversion of stock by a broker, the measure of damages is the value of the shares at the date of conversion.** Thus, the market value of the plaintiff's securities, not their cost, should be used to determine damages.

Defendants' reasoning is so contrived that even they cannot adhere to it for the length of their brief. Thus, although labelling plaintiff's use of the market value of his

* *H. K. Porter Co. v. Halperin*, 297 F. 2d 442 (7th Cir. 1961); *Atchison, T. & S. F. Ry. Co. v. Hadley Auto Transport*, 216 F. Supp. 94 (D. Colo. 1963); *Fehlhaber v. Indian Trails, Inc.*, 286 F. Supp. 499 (D. Del. 1968).

** *Solloway v. McLaughlin* [1938] A.C. 247, 258-259 (P.C.)

shares at the beginning of the complaint period a "fatal deficiency," when figuring the losses at the end of the complaint period, defendants employ this very same method. Defendants use the market values listed in DXUU, rather than the actual sale price to compute the losses incurred in the securities remaining in plaintiff's account. (Defendants' Brief, p. 15, App. A.5.) Thus, although defendants condemn plaintiff's method of determining losses, they, themselves, employ the very same method.

Moreover, not only do defendants advance a specious argument with respect to the plaintiff's mode of computation, but the selected figures which they use (Defendants' Brief I) are equally fallacious. While admitting that the figures are incorrect, defendants attempt to blame the charts prepared by plaintiff's bookkeeper. In reality, however, blame can only be placed upon defendants in wilfully misusing the plaintiff's figures.

Loew's Theatre, Inc. is a clear example of defendants' deceptive arithmetic. Defendants assert that the cost of the Loew's stock was \$40,965.18. The figure \$40,965.18 (PX 7) in no way reflects the actual amount of money paid by plaintiff, but constitutes an attempt by plaintiff's bookkeeper to apportion by percentage the relative cost of the shares after they had split. Had defendants taken the time to consult plaintiff's monthly statements, they would have seen that plaintiff's cost was \$90,349.80. (DX A).

Inaccuracies abound in defendants' garbled chart (Defendants' Brief App. I). The cost of Raytheon Co. is listed at \$51,941.50, when the actual cost was \$106,247.89 (DX A). Another example is Teledyne Inc.; defendants assert that the cost was \$57,639.88, when plaintiff actually paid \$124,989.48. (DX A). Defendants' chart does not note when securities were exchanged for other securities, whether the stock split, and how much of the sale price included dividends. All but one of the securities listed by defendants involve some complication not noted in their chart. For this reason, defendants' chart is not just worthless, but

actually harmful, since its information and, therefore, the conclusions based upon it, are incorrect. As the record clearly demonstrates, plaintiff's losses aggregate \$427,000.

POINT II

Stott is Liable for Losses Caused by the Purchase of Delanair

Defendants assert that plaintiff has no valid claim for any loss resulting from the purchase of Delanair. Their argument is based upon two contentions: (1) that neither Yamada nor plaintiff supplied Stott with any information concerning the Delanair purchase, and that Stott was, thus, merely an innocent bystander and (2) that plaintiff previously released Yamada from any further litigation concerning Delanair. Both contentions are fallacious.

A. Defendant Stott Was A Central Figure In The Decision To Purchase Delanair

Before the purchase of Delanair, defendant Stott was, with Yamada, actively managing plaintiff's account. Stott spoke with Yamada several times daily. Stott was making decisions in the management of plaintiff's account—what to buy and sell. In fact, before July 31, Stott had invested more of plaintiff's money than had Yamada. (DXUU, E-134-139).

The purchase of Delanair also involved Stott in the decision making process. Plaintiff knew that Stott was working closely with Yamada. Therefore, when Yamada proposed to plaintiff that he invest \$400,000 in unregistered securities, he went to Stott for advice. Plaintiff testified:

“In that period when Mr. Yamada recommended Delanair, and he said—he indicated the investment would be about \$400,000, and I thought that was quite a bit of money, so I called Mr. Stott, and I said, ‘Mike, what is this? This is a lot of money for me in this one security.’”

And Mike said 'Well, I think if Yamada said it was all right, it's all right. You can go ahead with it.'" (JA-96).

Plaintiff testified that he wanted the Delanair transaction to be made through BEDCO (JA-233), and that he was "worried" about it (JA-232). Yet, despite plaintiff's fears, Stott always had the same answer: "It is okay, if Mr. Yamada said okay, go ahead."

Thus, whatever the extent of his knowledge about Delanair, Stott counseled plaintiff to proceed with its purchase. Stott never expressed to plaintiff the reservations which he subsequently conveyed to Yamada. For after he had recommended the Delanair purchase to plaintiff, Stott then questioned Yamada about placing so much money in an unregistered stock. Stott complained that \$650,000, at this stage almost two thirds of plaintiff's account, was illiquid. (JA-574, 395). Stott's real concern was not for plaintiff, however, but for himself. The illiquid securities could not be used to generate commissions.

Defendants contend that Stott received no commissions from the Delanair transaction. However, Yamada opened two new accounts with Stott at the time of the initial Delanair purchase and another one later when the Delanair warrants were purchased.* (JA-641-643) The purpose of these accounts, as Yamada testified, was to give Stott other "quid pro quo" commission business. Furthermore, Stott used his knowledge of Delanair's unsuitability to coerce Yamada into increasing commissions. (JA-407; JA-395). Stott was thus, rewarded financially for his role in the Delanair purchase.

Thus, the record reflects, plaintiff looked to Stott for supervision and advice with respect to the proposed purchase of Delanair. Stott violated the trust placed in him by plaintiff when Stott, keeping doubts to himself for his own profit, recommended that plaintiff purchase \$400,000 of lettered stock. Stott is liable for the Delanair losses of \$400,000.

* Takara Partners, Armstrong Capital and Neuwirth.

B. Plaintiff Never Released Yamada From Losses Resulting From Delanair

Defendants refer to a previous lawsuit instituted by plaintiff to recover some of his Delanair losses. Defendants make a startling assertion concerning the settlement of that action:

“In connection with that settlement Rolf agreed that he would not require Yamada, in any forum thereafter, to testify as respects the Delanair transactions. (DX PP, ¶ 3 [E-107]).”*

Defendant's statement is grossly false. Yamada was not a party to, nor did he sign the settlement which clearly excludes him. Indeed, the paragraph preceding that cited by defendants (DX PP, ¶ 2 [E-107]) clearly directs defendants to the terms of Yamada's exclusion, which are contained in Exhibit B (E-118, 119):

“This release does not inure to the benefit of Yamada, any partnership or other entity through which he did business, provided, however, that whenever the terms ‘partnership or other business entity through which Yamada did business’ are used herein, they shall not be intended to pertain to or relate to any other persons or entities being released herein, their successors, heirs or assigns, and is not intended to release or discharge any claims, causes of action or suits, which plaintiff may have against Yamada, any partnership or entity through which Yamada did business, his successors, heirs or assigns and plaintiff hereby expressly reserves and excepts from this release any rights which he may have against Yamada, any partnership or other entity through which Yamada did business, their successors, heirs or assigns.”

The patently false contention that plaintiff released Yamada in a previous lawsuit is but another example of defendant's willingness to ignore the truth, no matter how glaringly obvious.

* Def. Br. p. 14.

POINT III

Stott is Liable for the Losses Resulting From the Purchase of Securities in Brokerage Houses Other Than BEDCO

When plaintiff entrusted the management of his account to defendants, he imposed one important condition: all trading was to be done through defendants BEDCO and Stott. (JA-91-98, 378, 682-683, 795). Yet, after less than one week, an account was opened in plaintiff's name at Lynch, Jones & Ryan and \$144,000 worth of Monarch securities were purchased through that firm. Subsequently, accounts were opened in six other brokerage houses and trades effected for plaintiff in each. Defendants claim that Stott and BEDCO can in no way be held responsible for purchases made in these outside brokerage accounts. Defendants base this claim on a three-pronged argument: (1) Rolf did not discuss with Stott the opening of any one of the accounts, (2) no commissions were earned by Stott or BEDCO on the purchase of securities at other firms and (3) neither Stott nor BEDCO recommended to Rolf or Yamada any of the securities "on which a loss was realized," nor had any knowledge of the purchases before they were made. Each of these arguments is either false or so distorted as to be misleading and meaningless.

Defendants assert that plaintiff "did not discuss the opening of any of these other brokerage accounts with BEDCO or Stott." The record reflects, however, that Rolf did discuss the opening of these accounts with Stott when plaintiff observed the quality of the securities being purchased in them. Many such securities were necessarily of poor quality, because in several cases new accounts were opened to obtain securities which could not be purchased at BEDCO. (JA-405; JA-396; JA-403). As always, however, Stott assured plaintiff that all was well. Plaintiff testified:

"He [Stott] said 'You have a custodial account and it doesn't make any difference, all the securities go

to Eastman Dillon and all the money is paid out from them, the transactions go across my desk and I can supervise it just like before.' " (JA-216).

Moreover, Stott discussed the opening of every account for plaintiff except one (Kordich, Victor & Neufeld) with Yamada. (JA-386; JA-389; JA-517; JA-392; JA-509; JA-396; JA-402; JA-404). Stott knew the accounts were being opened and the types of securities being purchased in them. His only complaint was that he was losing commission business. (JA-406).

Defendants' second assertion is that BEDCO and Stott earned no commissions on the purchases made at other houses. However, with one exception (M H Studio), Stott and BEDCO received commissions from the sale of every security on the list. In the case of three securities (Consolidated Oil & Gas, GPI and Visual Sciences), additional purchases were later made through Eastman Dillon. Thus, Eastman Dillon profited from every outside purchase, but one.

Defendants' final argument is that Stott and BEDCO did not have any prior knowledge of the purchase of securities "on which a loss was realized." With this fine distinction, defendants hope to separate three purchases (Consolidated Oil & Gas, Monarch Industries and Funeral Homes of America) from the others. Although defendants do not deny plaintiff's contention that Stott was, with one exception, an active participant in the opening of other accounts to buy speculative and manipulated securities, they maintain that he somehow did not know about the purchases at Lynch, Jones and Ryan where plaintiff lost most heavily. Defendants thus, appear to concede that Stott was involved in the opening of the other accounts, but hope to disassociate him from the Monarch purchase since it was this transaction which caused the most loss. The Trial Court addressed this tactic:

"While Yamada had the authorization, the court has found that Stott influenced Yamada's decision making

and recommended to Yamada stocks for Rolf. By these actions, Stott himself pierced the veil of any protection the power of attorney might have given to him or to BEDCO. A broker cannot recommend stocks to an investment adviser at will and then back off and claim he was no more than an 'order-taker when such judgments are challenged.' (JA-56) Yet, here in the case of Monarch (as well as in others), defendants attempt to do just that."

Defendants cannot disassociate themselves, however, since the record demonstrates that Stott was closely involved in the purchase of Monarch and was informed of it by Yamada, in advance. The initial purchase of Monarch was made less than one week after Yamada and Stott took over the account. It was made at an outside firm despite the strict instructions of plaintiff that all trading be done through BEDCO. Even Stott so testified at his deposition and at the trial:

"The witness: 'Was there any understanding that orders would be placed through Eastman Dillon?'

"A. If at all possible.

"Q. With whom did you have that understanding?

"A. With Dr. Rolf.

"Q. Also with Yamada?

"A. Well, he told Yamada.

"Q. To place orders wherever possible with Eastman Dillon and with you?

"A. With Eastman Dillon and yes, with me.' . . .

"Q. When you said that, was it true, Mr. Stott? Was that a truthful answer when you said it?

"A. Yes." (JA-682-683).

Despite these emphatic instructions, the Monarch purchase was made at Lynch, Jones & Ryan. Plaintiff testified that he made no complaint because he believed "that Mr.

Stott and Mr. Yamada were working closely together and each one knew what the other one was doing." (JA-214). Plaintiff's belief was indeed, correct. Stott did know that Yamada was opening a new account at Lynch, Jones and Ryan. Unlike Dr. Rolf, he also knew Yamada's fraudulent motives. Yamada testified:

"A. I had an office at Lynch, Jones & Ryan for awhile and a person connected with Lynch, Jones & Ryan introduced me to Mr. Stott and I needed to generate commission business to give to Lynch, Jones & Ryan.

"Q. Did you discuss the opening of that account with Mr. Stott?

"A. Yes, sir. Mr. Stott and I discussed the fact that I had to give commission business to Lynch, Jones & Ryan and this was one of the few brokerage houses that he was amenable to sharing commission business with." (JA-386).

* * *

"Q. Did you tell him you were acquiring the Monarch securities outside of the Eastman Dillon account?

"A. I believe that I had that discussion with him.

"Q. What did you tell him was the reason why those acquisitions were made outside of the Eastman Dillon account?

"A. In the case of Lynch, Jones & Ryan, I owed them commission business. In the case of Amswiss, I don't recall." (JA-455).

After the initial Monarch purchase, Stott questioned Yamada. Yamada wished to make another purchase of Monarch securities and he discussed it with Stott:

"Monarch was a substantial investment as a percent of the total portfolio, almost a quarter of a million dollars, and Mr. Stott was worried that I was beginning to tie up too much of the portfolio and he wanted to know about Monarch, and he also felt that he needed to

know because he might be asked by Dr. Rolf as to what the company did, etc." (JA-390).

Despite his reservations, reservations he never expressed to plaintiff, Stott went along with the second Monarch purchase. Although aware that too much of plaintiff's portfolio was becoming illiquid and that plaintiff was involved in what plaintiff's expert referred to as a "lockup," a security which he could not easily dispose of, Stott said nothing. He never expressed his doubts to plaintiff despite the fact that Stott had agreed to supervise plaintiff's account.

Yet Stott's complicity did not end with the purchase of Monarch. Fifteen hundred shares were sold through BEDCO in August, 1969, but the vast majority of the stock (9,800 shares) remained frozen in plaintiff's account. Plaintiff complained both by phone (JA-524) and by letter (PX 1, 3, 5) that Monarch was illiquid and that he wanted it "freed up." To quiet Dr. Rolf, Yamada finally sold 9,600 Monarch shares for \$70,800 in October, 1970. He invested that money in SEIJO, a worthless trust fund he was then starting. Before investing in SEIJO, plaintiff questioned Stott about that investment:

"... at that time I was worried and I said to Mr. Stott 'What do you think, should I go ahead with this' and he said, 'Oh, yes, if he has his family in there, you know, he is a bright guy and he will do all right.'" (JA-220).

Because of Stott's encouragement, plaintiff invested in the SEIJO fund and ultimately lost all of the Monarch proceeds invested in it.

Thus, the record confirms that from the beginning until the end, Stott knew the true nature of the Monarch transactions. Despite such knowledge, he approved and encouraged the investments made on plaintiff's behalf and never revealed the truth to plaintiff. Dr. Rolf's losses in both Monarch and SEIJO are direct results of Stott's complicity. Stott is likewise responsible for the losses in the other ac-

counts, \$154,152.50, as well as the loss in SEIJO, \$70,800, aggregating a total of \$224,952.50.

POINT IV

Stott is Liable for the Losses Caused by the Trades Effected at BEDCO

Defendants' final category of securities encompasses those purchased through BEDCO. Defendants contend that Scott is not responsible for losses realized on those stocks, despite the fact that Stott invested more money than Yamada at BEDCO and caused the vast majority of the losses incurred by plaintiff. Defendants divide the securities into three categories: those recommended by Stott, those which were rated lowest of low by plaintiff's expert, and the remaining securities which fit in neither category. It will be shown that Stott is liable for all of the losses incurred by the purchase and sales of these securities, but particularly those in the first two categories.

A. Stott Is Responsible For Losses Incurred By His Recommendations

When the plaintiff retained Stott and Yamada to manage his account, he clearly defined the roles of each. Plaintiff testified that after conversing with Stott, he concluded that although Stott was a "capable person," "mature" and "experienced," he was not an analyst. Plaintiff "didn't think [Stott] could generate concepts of timing, what to do, when to buy and sell." (JA-85) Plaintiff left his account with Stott, however, but asked that he "secure the services of an analyst" who would work with him. (JA-85-86) The investment adviser, whom Stott recommended, was Yamada. Yamada was to "generate investment ideas," while Stott "with his experience behind him," was to be "watching and supervising." (JA-93). The trial court credited Rolf's testimony, saying that plaintiff "sought to balance Yamada's youth and zeal with BEDCO and Stott's reliability and supervision," (JA-28).

However, from the first day of trading in plaintiff's account, Stott exceeded the supervisory duties assigned him. The very first purchase, Asamera, was effected by Stott. (JA-382, JA-437). Professing expertise in the oil business as a result of family connections, Stott caused six oil securities to be purchased for plaintiff. These investments total \$485,910.64; the losses they incurred aggregate \$103,604.08. Yamada, by his own admission, knew very little about the oil industry and relied on Stott in these purchases, since Stott professed to have "inside" contacts and information concerning the industry. Yet, although he had caused plaintiff to invest almost half a million dollars in oil stocks, on the stand, Stott denied having any special knowledge of the oil industry. (JA-817) Thus, since there is ample evidence in the record of Stott's claim to expertise in the field of oil securities, it is clear that Stott either misrepresented his knowledge of such securities to Yamada, or else, he lied on the stand.

Moreover, Stott was not content merely to recommend oil securities. He effected the purchase of six other securities for a total of twelve. Without ever determining what plaintiff's investment objectives were, (JA-777-778; JA-783), while professing to be merely an "order taker," Stott invested \$662,204.40 of plaintiff's money. Indeed, Stott, who claimed not to have been involved in the management of the account, except as a clerk, actually invested more money at BEDCO than did Yamada (\$544,286.43). Rather than supervising, Stott was generating more investment ideas (and commissions) than Yamada.

The record demonstrates that plaintiff had good reason for his decision to obtain an adviser with whom Stott was to work. Nearly all of Stott's purchases were heavy losers. The only two securities purchased by him showing a profit, were short-term purchases which netted the plaintiff \$660.71: International Funeral Services was purchased and sold the same day; Teradyne was sold two business days after its purchase in the very same week Stott wrote plaintiff to say that he was only an "order-taker." (DXUU,

E-148; E-156) The miniscule profits in those stocks in no way offset losses of \$172,364.14 in the remaining Stott purchases. Thus, the net result of Stott's investments was a loss for plaintiff of \$171,703.43.

Plaintiff clearly directed that Stott was not to originate investment ideas. His position was a supervisory one, to filter the ideas originated by Yamada. The evidence establishes that plaintiff intended Stott to play an overseer's role in the management of his account, and that Stott clearly exceeded the responsibility assigned him. He is, therefore, responsible for the losses incurred through his investments, namely, \$171,703.43.

B. Stott Is Responsible For Losses Incurred In Stocks Rated Lowest Of Low

Of the eighteen securities purchased for plaintiff by Yamada at BEDCO, nine were listed as "lowest of low."* These were for the most part, manipulated or highly speculative securities purchased by Yamada to give plaintiff quick, easy profits in order to mollify him (JA-409). Of the three securities which caused a loss for plaintiff, Synchronex, Hair Extension and Holobeam, two were manipulated and the other was rated "highly speculative" by Yamada (JA-499; JA-483; JA-400). There is no question that these securities were unsuitable for plaintiff. They were shell companies whose false value was derived from manipulation. In the case of Hair Extension, a stock Yamada would not have purchased had it not been manipulated, plaintiff was able to sell only 2,000 of his 5,000-shares and "got caught with the balance." (JA-484).

Although well aware of the purchases and their obscure and speculative nature, Stott never objected or informed plaintiff of their lack of investment merit. Rather, he assured plaintiff that he ran no risk. Stott is, therefore, liable for the losses which aggregate \$24,207.79.

* Creative Polymer, GPI Enterprises, Hair Extension, Health Evaluation, Holobeam, Synchronex, Tele-Communications and Visual Sciences. Firefly is omitted because it was purchased after December, 1970.

**C. Stott Is Responsible For Any Losses Caused By
The Purchase And Sale Of The Remaining Securities**

Defendants' final category consists of eight securities* purchased at BEDCO, but not rated lowest of low. Plaintiff does not separate them from the other fraudulent transactions. In every case, they were purchased at a time when either plaintiff was complaining about his losses or Stott about his lack of commissions. The purpose of these transactions was either to silence Dr. Rolf's complaints, or Stott's. As might be expected, all but one security involves purchases and sales less than three weeks apart. The one exception, Outlet Co., was sold five weeks after its purchase.

While maintaining that these transactions are part of defendants' overall fraud, plaintiff acknowledges that they caused losses of only \$331.31. Plaintiff contends that they facilitated the fraudulent transactions which caused much greater damage and that they must be viewed in that light.

PART TWO

Statement of Facts

A. Plaintiff's Investment Objective Was Safe Capital Growth

Defendants falsely assert that the "Trial Court expressly found that Rolf was a sophisticated investor." (Def. Br. p. 28). In actuality, the Trial Court found that certain events "undercut" plaintiff's "claim that he was an unsophisticated investor." (JA-24) Defendants take an unwarranted liberty when they change the Trial Court's statement into a positive assertion. Only after examining the events leading up to the complaint period, and those which occurred during it, can one judge how seriously they do, in fact, "undercut" plaintiff's claim.

As plaintiff testified, he was over sixty years old at the time of the complaint period. Plaintiff's stock portfolio represented his entire savings, his retirement nest egg.

* Plaintiff does not include Consolidated Oil and Gas in this list but in the list of securities purchased at other brokerage houses, since Stott testified that it was purchased only to cover a mistaken long sale.

Dr. Rolf had no pension and no retirement plan; his future was bound up in those securities. Therefore, it is not surprising that plaintiff was most concerned that no risks be taken with his portfolio.

For almost six years prior to the complaint period, plaintiff's account had been managed by S. Logan Stirling. The Trial Court quite correctly states that plaintiff made no complaint about the securities purchased by Stirling. However, although the Trial Court adds that certain of those securities were "aggressive investments," an examination of the securities purchased for plaintiff's account by Stirling reveals the standards employed by the Trial Court in using that phrase.

Stirling purchased 114 different securities for plaintiff's account during the six years he managed that account. Of those 114 securities, 111 were either listed on the New York Stock Exchange or American Stock Exchange; one was on the Pacific Coast Exchange and the other two were warrants of listed securities. (DXA) It was very easy for plaintiff daily to keep track of his securities; he merely had to open his morning paper. The quality of the Stirling securities reveals plaintiff's intent. For, as plaintiff's expert testified, issues traded on organized exchanges "tend to be higher quality than a portfolio consisting of issues which are not traded on organized exchanges." (JA-123) He stated that "where securities are actively traded, there would tend to be a quality consideration to have a portfolio consisting of actively traded securities rather than lockups." Plaintiff's expert defined lockups as the ownership of "a security that you can't sell in an orderly market." (JA-123).

In the six years Stirling managed plaintiff's account, he never once purchased a lockup. Information with respect to the plaintiff's securities was available in any large newspaper. There was never the possibility that plaintiff would not be able to sell a security. As a result of the quality of the stocks purchased for him, plaintiff took minimal risks and was never in danger of losing his equity. If the Trial Court found investments made by Stirling to be aggressive

investment interested in capital gains but entailing little risk, then plaintiff was aggressive. Indeed, registered, low risk stocks were what Yamada meant when he labeled the Stirling portfolio (Y XA) "aggressive." He stated:

"Let me preface my answer by saying what I try to define in this context of what I mean by aggressive, speculative, or investment mer(it) or what have you: As opposed to some of the securities purchased in Dr. Rolf (during the complaint period), all these stocks could be considered aggressive investments in the sense that they were all listed—as near as I can tell they were all listed on a national stock exchange, and they all were fairly active traded companies. So, in terms of the risk, the market risk of not having a definable market or being able to sell size, *I don't think any of these stocks carried a risk*, whereas the other stocks purchased in Rolf's portfolio [by Yamada] definitely did." [emphasis added] (JA-431).

Defendants characterize the management of plaintiff's account during the complaint period as "continued aggressiveness," implying that the account was run by Stott and Yamada in a manner similar to that of Stirling. (Def. Br. p. 29). If such were the case, then all of the securities purchased by Stott and Yamada would be traded on an organized exchange with information available in almost any newspaper and no risk of lock-ups. Such, however, was not the case. Almost one half of the securities purchased (19 of 41) were not listed on an exchange; three did not even file with the SEC. Not only was information not available in the newspapers, but seven companies were not even in Moody's Manual. Finally, after plaintiff had invested with BEDCO for six years with minimal risks, the two biggest investments made on his behalf by Stott and Yamada were made in "lockups," Delanair and Monarch.

The evidence is clear that both Stott and Yamada knew that the Delanair and Monarch purchases were lockups, and that they involved risks plaintiff was not willing to take. In fact, Stott specifically asked Yamada what to tell the doctor when he questioned the investments. (JA-390).

And he did question them by phone and by mail. The letters constantly refer to a "work-out in Delanair and Monarch Industries." (PX3, E6; PX1, E2; PX5, E.11). Plaintiff phoned Yamada constantly, indicating that he did not want to risk his equity

Defendants constantly assuaged plaintiff's fears about his securities. Since his portfolio contained plaintiff's entire savings, his retirement nest egg, he worried about investments made in such securities as Monarch and Delanair. But whenever plaintiff expressed these worries, he was told by Stott that "you don't have anything to worry about, we know what we are doing." (JA-217). Plaintiff stated: "During the entire period, Stott and Yamada were working together on this, I don't remember a single instance, not one, where there was any element of risk introduced . . . Everything was sort of pre-ordained." (JA-223).

It was Yamada and Stott who "pre-ordained" the affairs in plaintiff's account and promised him riskless rewards. The projections of how much money plaintiff would make all came from defendants. The letters reveal how Yamada projected the outcome of investments:

"Aki is going to send me a definitive outline of our equity plan regarding the \$2,400,000." (PX4 E. 9).

"We invested about \$650,000 into Delanair and Monarch on the proposition that 'Delanair will come out at 18 and Monarch will double.' " (PX3, E. 6) "If your [Yamada's] projection of \$800,000 or better for Delanair works out . . ."

"In summary, you [Yamada] are projecting an equity position of \$1,500,000 . . ." (DXH, E68).

Yamada was not alone in making projections. In December, 1970, when plaintiff's account was completely decimated, he still was encouraged by Stott and led to believe that plaintiff's investments would ultimately prosper. Thus, in a letter to Stott, plaintiff stated: "As soon as we reach that figure, Mike, that you and I discussed, I am coming to New York and we will throw one big party." (PX5, E-12).

Accordingly, the record reveals, it was a combination of fraudulently optimistic projections and repeated assurances that there was no risk, by not one, but two trusted advisers, that persuaded plaintiff to allow his investments to be changed so radically. Defendants found an investor who was "confused and groping" and made their alleged objectives his. This was primarily accomplished by one means, the constant confirmation by Stott that there was no risk. Throughout the period, it is evident that plaintiff never realized the risks he was taking. Even in the letter cited by defendants (Defs. Br. p. 33; PX3, E-6), when plaintiff was under "increasing pressure to have (his) equity restored or augmented," he still clung to his original investment intent: "The old rule that the preservation of capital is the first rule of investment has never been more true." (PX 3, E-7).

Plaintiff allowed defendants to invest his money because he thought there was little risk. Indeed, he had sought to minimize risk by engaging Stott in a supervisory capacity. Without Stott's successful "hand-holding," defendants' fraud would not have been possible. Stott was crucially involved in influencing the plaintiff's state of mind, and is, thus, responsible for the losses he suffered.

B. Plaintiff Did Not Refuse To Permit Stott To Handle His Account, And In Fact, Stott Did Handle That Account

Defendants' assertion that plaintiff refused to permit Stott to handle his account is totally refuted by the fact that Stott did, in fact, handle it. Defendants cite out of context, plaintiff's assertion that he did not want Stott to handle his account. As the record and plaintiff's citation reflect, plaintiff stated only that *at that time*, i.e. after his notification of Stirling's death, plaintiff did not want Stott to handle his account. (JA-102, emphasis added) *At that time*, plaintiff was attempting to find a single individual of Stirling's calibre to act as plaintiff's investment adviser. In fact, however, the plaintiff was unable to do so, and retained instead, Yamada and Stott, a combination which

plaintiff testified, and the Trial Court found, plaintiff believed would produce a "Stirling-type operation." (JA-29). Thus, the evidence clearly establishes, although plaintiff did not initially want Stott to handle his account or to do so alone, he ultimately retained him to do so in conjunction with Yamada, "balancing Yamada's youth and zeal with BEDCO and Stott's reliability and supervision." (JA-28).

Accordingly, the record is clear that although plaintiff had engaged Yamada to generate investment ideas, he retained the services of Stott in a supervisory capacity:

"Well, I had told Stott that I want to have a Sterling type of operation. I was very happy with Mr. Sterling and if we could continue that way, it would be great, and I thought perhaps a young man as bright as Yamada, he could generate investment ideas and tell us what to do and with Mike Stott, with his experience behind him, kind of watching and supervising this thing, and I also thought at Eastman Dillon, Mr. Sterling told me they had one of the best research departments in the country, and I thought that would be a backup.

I felt maybe we could have a Sterling-type operation. (JA-93).

"THE WITNESS: I told Mr. Stott that 'I am going to leave the securities here, just like we did with Mr. Sterling. You watch this account, you supervise it.' I said, 'You are going to be getting all the commissions from these transactions and it is to your advantage to watch it carefully.' " (JA-213).

The record abounds with evidence that Stott handled plaintiff's account. Plaintiff directed that all business be done through Stott; Stott effected purchases and sales; Stott, not Yamada, spoke to Dr. Rolf every day after April 15, 1970, seven or eight days a month before that. In April 1970, plaintiff wrote "you work closely with Aki." (E-2) In October, plaintiff was even more explicit: "Remember, you're my man in New York. *Please keep the program on target.*" (E-3, emphasis in original.) In De-

cember, plaintiff ended his letter to Stott, "With kindest personal regards, and keep your pulse on the situation and also keep me informed."

The evidence supports plaintiff's assertion that he asked Stott to supervise his account. Defendants are correct when they say plaintiff had reservations about Stott. But they omit to state that plaintiff also had reservations about Yamada. The very qualities plaintiff felt Yamada lacked, maturity and experience, were, he believed, Stott's strongest qualifications. Stott and Yamada complemented each other perfectly in plaintiff's eyes, and so he retained them both. That Stott never met plaintiff until October 1970, did not stop him from becoming the doctor's "man in New York."

The evidence shows that plaintiff wanted Stott and BEDCO* to supervise his account. The Trial Court so found and the record supports that finding. The evidence also shows that Stott "was intimately involved with the management of the account." The trial court also correctly ruled this to be true. Indeed, through July 1969, in every case but one, the decision to buy a security for Dr. Rolf at BEDCO was made by Stott. Yamada purchased only U.S. Natural Resources and then sold it two business days later, providing a large commission the very day that the money in the initial Monarch purchase was due and Stott had complained. Stott's management of plaintiff's account demonstrates that the defendants' claim is without foundation.

C. Plaintiff Trusted BEDCO and Wished His Account To Remain There

Defendants' argument that plaintiff's "'selection' of BEDCO was hardly purposeful" and their implication that plaintiff only maintained after the fact, that he wished his account there, is most puzzling. For, until now, plaintiff's purposeful selection of BEDCO was an unquestioned

* Indeed, the evidence reveals, plaintiff not only based his trust in BEDCO upon the fact that it was "a reputable brokerage house," but his opinion that it was "great." (JA-219).

fact of this case. All of the parties involved in plaintiff's choice testified that plaintiff specifically voiced his wish that the account remain at BEDCO. Yamada stated this, testifying that plaintiff believed BEDCO to be a "substantial house" and that he wished that firm to "monitor his account." (JA-378, 379) Rolf stated this:

"Q. Did you tell Mr. Yamada your reason for wanting him to work with Mr. Stott?

"A. I told Mr. Yamada to have all the securities go through Eastman Dillon and I said it was a large brokerage house, I felt comfortable there, and I said Mr. Stott could watch this and the two of you can work together, and we will have a good arrangement." (JA-91)

Even Stott confirmed it in both his deposition and his testimony at the trial:*

"THE WITNESS: Was there any understanding that orders would be placed through Eastman Dillon?

"A. If at all possible.

"Q. With whom did you have that understanding?

"A. With Dr. Rolf.

"Q. Also with Mr. Yamada?

"A. Well, he told Mr. Yamada.

"Q. To place orders wherever possible with Eastman Dillon and you?

"A. With Eastman Dillon and yes, with me." (JA-682, 683).

* * *

"Q. Prior to that telephone conversation, I believe you testified that there was an understanding you had

* That Stott testified to this on both occasions substantiates plaintiff's assertion, since on several crucial issues, Stott was not reluctant to contradict his previous testimony.

with Dr. Rolf that Mr. Yamada was to place orders wherever possible with Eastman Dillon through you?"

* * *

"A. Dr. Rolf had said to me that he wanted his account to stay at Eastman Dillon because it had been there for some six or seven years and he would like the account to stay there." (JA-795, 796).

The factual evidence that the selection of BEDCO was significant to plaintiff is overwhelming and is not rebutted by the defendants' muddled logic. That plaintiff would have paid the same brokerage commissions at other houses does not in any way demonstrate that his choice was a random one. On the contrary, the record is replete with evidence that plaintiff specifically chose BEDCO as his broker because of his strong confidence in that firm.

D. Plaintiff Selected Yamada Upon The Recommendation of Stott

The defendants' description of Stott's first conversation with plaintiff brings full circle the story begun at Stott's deposition. Then, when asked how much information he gave plaintiff about Yamada, Stott stated merely that he had given plaintiff two names and two telephone numbers:

"Q. You didn't tell him anything about their background and investment, is that correct?

"A. That is correct. No.

"Q. So you just said 'here is two names, Yamada and Geddes?'

"A. Yes—he had a couple that he was going to see in Boston and that was the last I heard of him.

"Q. And did you give him telephone numbers?

"A. Yes." (JA 751-752).

At the trial, Stott changed his story, calling his earlier clear testimony a "misunderstanding." He then admitted that he gave plaintiff a "thumbnail sketch" of Yamada.

(JA-732). He told plaintiff that Yamada was from a fine family in Japan and that his father was president of Yamada Iron & Steel. He spoke of conversations with Mr. Ely at Kuhn Loeb concerning Yamada's position and record there. He listed the clients whose accounts Yamada handled. (JA 611-612). Stott's testimony was similar to that of Dr. Rolf. (JA 87). However, when asked whether this "sketch" which he testified to at the trial, was in his deposition, Stott stated, "No, it is not." (JA-732).

Now, in their brief, defendants return to Stott's original story in an apparent effort to choose a version which better suits their argument. In this case, however, the attempt is pointless. Plaintiff's testimony is quite clear and nowhere is it disputed by Stott:

"Q. Did you tell Mr. Stott that you would recommend and investment adviser to work with him?

"A. No.

"Q. Did you ask Mr. Stott for a recommendation as to an investment adviser?

"A. Yes.

"Q. Did Mr. Stott make such recommendation?

"A. Yes.

* * *

"Q. Who did he recommend to you?

"A. Two people, Mr. Donald Geddes of Inverness Management and Mr. Akiyoshi Yamada." (JA-86).

"Q. Did you at that time discuss with anyone other than Mr. Stott the selection of a person to advise you on investment?

"A. No, not that I recall." (JA-102).

Of the two investment advisers recommended by Stott, plaintiff chose Yamada, even though he had never heard of

him before. (JA-217). There was no need for plaintiff to consult Stott prior to retaining Yamada's services, for Stott, himself, had recommended Yamada as someone with whom Stott could work. Indeed, plaintiff believed the two to be close friends. (JA-106).

The record makes quite clear that plaintiff's decision to retain Yamada was based upon Stott's recommendation. Even defense counsel characterized Stott's referral as a recommendation (JA-103). Plaintiff gave Yamada a trading authorization only on the understanding that Stott would oversee Yamada's transactions.* (JA-91) The decision to hire Yamada was the first of many decisions in which plaintiff relied on the advice of Stott, to plaintiff's own detriment.

E. Yamada's Reputation Was Not A Consideration In Stott's Recommendation

Defendants argue that "Yamada's reputation at the outset was first rate", implying that this might have been a factor in Stott's recommendation of Yamada to plaintiff. This argument is unsupported by the evidence which demonstrated that Yamada's reputation played little, if any, role in Stott's choice. If Stott had, in truth, sought to recommend any investment adviser to serve plaintiff's needs, Stott could have referred plaintiff to a partner in BEDCO, as plaintiff had requested.** Then Stott could have been certain of the competence of the person recommended and need not have relied upon "reputation." Had he done so, however, Stott would have lost the commissions generated by plaintiff's account.

* Unlike Stirling, Stott could not handle a discretionary account at BEDCO.

** Both plaintiff and Stott, at his deposition, testified that plaintiff had requested that a partner at BEDCO handle his account. (JA-802). At the trial, Stott denied that plaintiff had asked for a partner at BEDCO, stating that his testimony to the contrary at his deposition "wasn't the truthful answer." (JA-808).

Moreover, the record indicates that the extent of Stott's knowledge of Yamada's reputation was scanty and that Stott made little effort to ascertain Yamada's competence. Stott testified that he had two or three lunches with Yamada at short order restaurants, during which they discussed not investment, but sports, (JA-727) and that Stott had had a three to five minute conversation with Mr. Ely concerning Yamada, a conversation held at Stott's golf club. (JA-728). At the time he recommended Yamada to plaintiff, Stott had no knowledge of the type of accounts Yamada had managed at Kuhn Loeb (JA-772, 773) or the number of individual accounts that Yamada was then managing. (JA-777). Although he knew of certain substantial investors who were "entrusting moneys" to Yamada, Stott testified that he "found out later" that such investors were actually investing in a hedge fund operated by Yamada. (JA-932) Stott did not know how much such persons had invested in the hedge fund or the total amount invested therein. (JA-777). Thus, the record indicates, Stott recommended Yamada to Rolf with minimal knowledge of the former's past performance and none of the latter's investment intent:

"Q. Did you know what he (Yamada) was supposed to do for Dr. Rolf?

"A. No. I never knew what Dr. Rolf's objectives in his account were." (JA-721).

Thus, although Stott knew nothing about the plaintiff's age, income, financial situation and investment goals (JA-836), Stott went outside the firm to recommend Yamada, an adviser about whose competence he knew very little. Stott's motive in so doing can be gleaned from the record. It was Bob Devaney of Lynch, Jones & Ryan who introduced Yamada to Stott. The record is clear as to how Yamada did business with that broker-dealer. Obviously, Stott hoped for a similar arrangement and the record establishes that he obtained one. Defendants' argument that Stott's recommendation was based on Yamada's reputation is specious; that recommendation was based on Stott's greed.

F. Yamada's Prior Record Was Considered By The Court In Rendering Its Decision. Yamada's Testimony Was Corroborated By Other Evidence.

It is not surprising that defendants refer to Stott's prior "unblemished professional life"* to support their claim that Stott is a more credible witness than Yamada. Defendants do not ask the court to examine Stott's testimony at his deposition or at trial, because the only conclusion which can be drawn from such evidence is that in many instances, Stott was a liar. Indeed, it is Stott, not Yamada, whose testimony is in "doubt."

The Trial Court clearly noted Yamada's past record in its decision. But it also observed that "on many points Yamada's testimony is supported by that of Rolf or by documentary evidence." (JA-24). The Trial Court was careful to credit Yamada's testimony only when it was supported by other evidence. And the evidence, when available, consistently supported Yamada's testimony.

An example of the court's caution can be found in its treatment of the cross-index (PX 25) supplied by defendant Stott. It played a crucial role in the Trial Court's decision to credit Yamada's testimony concerning the number of securities which Stott had recommended. In crediting Yamada, the Trial Court specifically noted "that Yamada's testimony as to the twelve issues allegedly recommended by Stott was given *before* defendants produced the documents constituting the cross-index PX-25." Thus, as throughout the record, Yamada's testimony was reinforced by other evidence.

Moreover, an examination of the record not only affirms Yamada's credibility, but demonstrates that it was Stott, not Yamada, who fabricated testimony for the trial, completely reversing that which he had given at his deposition.

* Such allegations are unsupported by record cites.

when Yamada was in prison. It was Stott who, at his deposition, testified that plaintiff had requested a BEDCO partner to manage his account, and then testified in court that he had been "mistaken." Again, it was Stott who, at his deposition, claimed to have given plaintiff only two names and phone numbers of investment advisers, but on the trial, expanded that testimony to include a "thumbnail sketch." It was Stott who, at his deposition, lied as to how many times he had spoken on the phone to Yamada during the complaint period, stating a total of "twenty or thirty times," and later, admitted daily contact. Finally, it was Stott who, at his deposition, vehemently claimed to be only an "order-taker," yet ultimately admitted recommending the purchase of securities for plaintiff's account. Even then, however, Stott selectively chose to acknowledge the purchase of those securities which caused plaintiff the least financial loss. In every case, Stott altered his testimony to deal with that of either plaintiff or Yamada. Thus, the record clearly shows that Stott, not Yamada, is the witness with the "credibility problem."

Moreover, it is because Stott lied at his deposition and continued to conceal his own fraudulent actions that plaintiff released Yamada in this action. Such release was designed to elicit the truth, for even Dr. Rolf did not know the full scope of the defendants' fraud. Thus, it was Stott, who made necessary Yamada's release.

Yet Yamada is not the only beneficiary of Stott's coverup, for Stott, himself, appears thus far, to have profited from his misdeeds, losing the commissions he earned from the Rolf account, but pocketing the profits from the other business his relationship with Yamada generated. Enriched by his fraudulent actions, Stott righteously protests his good name, despite the knowledge that his disregard for the truth has been a profitable policy. Defendants' brief asks this court to ignore the record and look at Stott's "exemplary life." One need only examine the evidence to see what a faulty suggestion this truly is.

POINT V

The Trial Court Erred in Failing to Allow Plaintiff's Claim for Trading Losses. Such Losses Were Caused by the Defendants' Fraud.

When defendants Yamada and Stott assumed control of the Rolf account, plaintiff's portfolio was worth approximately \$1,423,000. At the end of December, 1970, the last month in which defendants had control over the account, plaintiff's portfolio aggregated only \$125,000.* Defendants do not dispute these figures, or offer alternate ones. Thus, it would appear unquestioned that the value of plaintiff's portfolio declined \$1.3 million during the period of the defendants' stewardship.

Defendants do not contest the figure representing plaintiff's overall loss, but rather dispute plaintiff's method of computing that figure. Defendants contend that plaintiff "has lumped and bunched together all of these different securities transactions just described without discrimination, distinction, or description." (Defs.' Br. p. 22). Defendants offer their own method of grouping the losses on plaintiff's account; they divide the transactions into four different categories: 1) losses incurred by the liquidation of the Stirling portfolio, 2) losses incurred by the purchase of the Delanair securities, 3) losses incurred by the purchase of securities at brokerage houses other than BEDCO, and 4) losses incurred by the purchase of securities at BEDCO.

Conceding, *arguendo*, that such a grouping is more clear and accurate, plaintiff will compute the plaintiff's damages using defendants' structure. The end result is, however,

* Because of the terms of the purchase agreement, plaintiff was unable to sell any of his Delanair securities. The value given in defendants' Exhibit UU reflects the open market value; the restricted stock which plaintiff possessed was worthless.

the same: the losses in plaintiff's account total approximately \$1.3 million.

GROUP I: Defendants liquidated plaintiff's account, without his prior knowledge and in a reckless and fraudulent manner. Defendants were not motivated by investment considerations, but by a desire for buying power and commission business. Losses aggregate \$427,000.

GROUP II: Defendants purchased for plaintiff \$400,000 worth of Delanair securities, including both stock and warrants. It was a grossly unsuitable security for plaintiff and the terms of the purchase agreement were misrepresented to him. Plaintiff lost his entire investment. Losses aggregate \$400,000.

GROUP III: Defendants purchased for plaintiff securities at other brokerage houses, despite explicit instructions by plaintiff to the contrary. These new accounts were opened for the purchase of securities which were too low in quality to be purchased at BEDCO, or to pay back some of Yamada's debts. Losses, including SELJO, aggregate \$224,952.50.

GROUP IV: Purchases were made at BEDCO which fall into three categories:

(A) Stott purchased securities for plaintiff, exceeding the guidelines laid out by plaintiff, and despite the fact that by his own testimony, he never knew, nor did he even attempt to ascertain what were plaintiff's investment objectives. Losses aggregate approximately \$171,703.43.

(B) Defendants purchased for plaintiff manipulated and "lowest of low" securities of shell companies with no investment merit. Losses aggregate \$24,207.79.

(C) Defendants effected short-swing purchases to generate commission and also quick profits to placate

plaintiff and thus, facilitate their larger frauds. Losses aggregate \$331.31.

Total losses from all purchases of securities effected at BEDCO aggregate -----	\$ 196,242.53
Commissions and interest ag- gregate -----	57,790.00
Total Losses Aggregate Ap- proximately -----	\$1,303,985.03

Plaintiff, in a previous judgment recovered \$175,000 for the Delanair purchase. Damages remain of \$1,128,985, the same approximate figure as given in plaintiff's original brief (Pl. Br. p. 18), \$1,130,000.

Moreover, even conceding, arguendo, that the plaintiff's loss calculations are imprecise, it was defendants' own conduct which rendered them so. Both Yamada and Stott spun a complex and interacting web of deceit, from which the defendants should not be allowed to profit. "[T]here is an inverse relationship between the degree of certainty required and the degree to which a party's wrongdoing infects more certain means of proof. This is no more than an expression of the maxim that one bears the brunt of one's own wrongdoing, here the risk of imprecise proof."* The proof adduced in this case supports the application of this principle.

The contention that some damage to plaintiff resulted from general market decline and that, accordingly no losses should be recompensed is also a fallacious one. If such were the case, a discount could be applied to the damages awarded. Moreover, as one court has observed, a declining market cannot insulate wrongdoers from liability. In

* *L.C.L. Theatres, Inc. v. Columbia Pictures Industries, Inc.*, 421 F. Supp. 1090, 1102 (N.D. Tex., 1976).

Gottreich v. San Francisco Investment Corporation,* the court held that damage causation had been pleaded, despite a claim of general market decline:

“Defendants argue that the complaint does not adequately plead causation or damages because the Gottreichs’ loss can be explained by a general decline in stock prices rather than by the Gottreichs’ reliance on any representations made by the defendants. This argument is meritless. The Gottreichs do not charge that the defendants’ misrepresentations caused the market price of the securities to go down. They charge that the defendants’ misrepresentations caused them to make and hold investments in a declining market. They relied on the misrepresentations; thus causation is adequately alleged.”

Thus, plaintiff contends, in view of the fact that the trial court found that the conduct of the three defendants operated as a fraud upon plaintiff, that his account was managed in a “generally” fraudulent way, and that the purchase of Delanair constituted a fraud, the court’s failure to allow any trading losses constituted clear error.

POINT VI

The Trial Court Erroneously Failed to Award Pre-judgment Interest.

The very cases cited by defendants support the plaintiff’s contention that pre-judgment interest should be awarded. Thus, in *Fox v. Kane Miller Corp.*,** the court enumerated the factors to be used in determining whether or not

* 552 F. 2d 866 (9th Cir. 1977). See also *Fottler v. Moseley*, 185 Mass. 562, 70 N.E. 1040 (1904).

** 398 F. Supp. 609 (D. Md. 1975), *aff’d*, 542 F. 2d 915 (4th Cir. 1976), citing *Norte & Co. v. Huffines*, 416 F. 2d 1189 (2d Cir. 1969), *cert. denied, sub. nom Muscat v. Norte & Co.*, 397 U.S. 989 (1970).

to grant pre-judgment interest in 10b-5 cases. "Those factors include 'fundamental considerations of fairness,' the degree of personal wrongdoing on the part of the defendants, whether such interest would be truly compensatory, the availability of alternate investment opportunities to the plaintiffs and the possibility that the time between the occurrence of the violation and the award of the judgment may have been intentionally prolonged by the plaintiffs. . . . A further consideration in weighing the issue of prejudgment interest in this case would appear to be the decline in the purchasing value of the dollar since June 3, 1969 as the result of inflation of which this Court believes it can and should appropriately take judicial note." (p. 651)

In this case, application of the factors set forth in *Fox* indicate that an award of interest should have been made. It would be "fair" for plaintiff to receive interest on his life savings, the defendants' behavior was culpable, interest would be compensatory and the plaintiff did not prolong this litigation. Further, the rate of inflation since the time of the wrong herein has clearly reduced the benefit of any award plaintiff received or might receive. "In sum, and on balance, the scales tip toward the award of prejudgment interest."* And the court below erred in failing to make such an award.

POINT VII

The Evidence Clearly Supports the Trial Court's Finding of Aider-Abettor Liability on the Part of Defendants Stott and BEDCO.

Although defendants "accept it as decided" in this Circuit that 10(b) liability can be incurred by one who merely "aids and abets," they cite considerable authority for the proposition that mere negligence in the management of a

* *Id* at pp. 651, 652.

customer's account does not give rise to 10b-5 liability.* Based upon such authority and a myopic view of the record, defendants assert that "Stott's conduct at most constitutes negligence which is wholly insufficient to substantiate a 10b-5 claim." The evidence, however, clearly establishes the contrary, since the record contains ample confirmation of the trial court's finding of scienter on the part of Stott.

A. The Fraud Which Defendants Aided and Abetted

The trial court found that "the plaintiff has proven that Yamada defrauded the plaintiff through the Delanair transaction and that he breached his own fiduciary duties owed to the plaintiff by means of his investment advisory agreement." The court concluded that "Yamada's handling of the Rolf accounts was generally of a fraudulent nature." The court found "that the securities purchased by Yamada as a part of his manipulative schemes were unsuitable for the plaintiff." Further, it held, "the *complete* transformation of the Rolf account from one containing 23 listed issues of reputable quality to an account made up of the likes of Hair Extension Centers, Health Evaluation Systems, and M. H. Studios," operated as a fraud upon Dr. Rolf (JA-64, emphasis added). The defendant Yamada's violations, the court stated, "were not merely 'tantamount to fraud' but rather constituted a gross fraud." (JA-68) Thus, the "independent wrong" established by plaintiff was both grievous and pervasive in nature, and constituted not a single transaction, but rather, a continuing fraud, spanning a period of almost two years.

B. The Record Establishes Stott's Knowledge Of Wrongdoing On The Part Of Yamada

The trial court's conclusion of knowledge of Yamada's "egregious violations" on the part of Stott is amply supported by the record. Indeed, the record abounds with

* Plaintiff does not quarrel with that proposition, but contends that it is inapplicable to the facts of this case.

numerous circumstances evidencing Stott's awareness of Yamada's fraud:

1. *Despite The Fact That Plaintiff Requested That All Transactions Be Effected Through BEDCO, Stott Condoned Trading At Other Brokerage Houses.*

At the outset of the Yamada-Stott stewardship, the plaintiff instructed Stott that all trades were to be made through BEDCO because of plaintiff's confidence in that firm. Despite that fact, defendant Yamada opened accounts for the plaintiff at brokerage houses other than BEDCO. Yamada testified that in at least one instance, he notified Stott in advance of the opening of an outside account and that Stott acquiesced in that action:

"Q. Did you place that order in Lynch, Jones & Ryan?

"A. Yes, sir.

"Q. What was your reason for placing the order in Lynch, Jones & Ryan?

"A. I had an office at Lynch, Jones & Ryan for awhile and a person connected with Lynch, Jones & Ryan introduced me to Mr. Stott and I needed to generate commission business to give to Lynch, Jones & Ryan.

"Q. Did you discuss the opening of that account with Mr. Stott?

"A. Yes, sir. Mr. Stott and I discussed the fact that I had to give commission business to Lynch, Jones & Ryan and this was one of the few brokerage houses that he was amenable to sharing commission business with." (JA-386)

Stott denied that Yamada had discussed in advance the opening of outside accounts with him, but admitted that he knew about their opening shortly afterwards:

"Q. You knew about these accounts shortly after they were opened, didn't you?

"A. Yes." (JA-820)

Although aware that transactions were being effected for plaintiff at outside brokerage houses, contrary to plaintiff's instructions, Stott testified that he never questioned Yamada about such accounts, even though most of the stocks purchased therein were of a quality which could not be bought through BEDCO (JA-823):

"Q. Did you ever ask Mr. Yamada how come he was opening accounts in other houses?

"A. Mr. Yamada—

"Q. Did you or didn't you, sir?

"A. No." (JA-820)

Plaintiff testified that he did not initially question Stott about the opening of outside accounts because plaintiff believed that "Mr. Stott and Mr. Yamada were working closely together" and that both were involved in the outside transactions. (JA-214) Plaintiff stated that he subsequently questioned Stott about the outside accounts when plaintiff noticed that "the quality of the securities" in such accounts "changed precipitously" and he became worried "as to whether [his] account was secure with these small brokerage houses that [he] personally had never heard of." (JA-215) Stott assured plaintiff that the outside brokerage accounts should cause him no worry:

"Q. What did Mr. Stott say to you?

"A. He said, 'You have a custodial account and it doesn't make any difference, all the securities go to Eastman Dillon and all the money is paid out from them, the transactions go across my desk and I can supervise it just like before.'

"Q. Did you ask Mr. Stott the reason, if any, for trading in accounts other than Eastman Dillon?

"A. Yes. He said Eastman Dillon didn't engage—trade in certain types of securities and I felt, well, if

Eastman Dillon didn't trade in the securities maybe they didn't belong to my account.

"Q. Did you convey that feeling to Mr. Stott?

"A. Yes.

"Q. What did he say to you?

"A. He said, 'Aki and I work closely together and you don't have anything to worry about.' He always said, 'You don't have anything to worry about, we know what we are doing.' " (JA-216, 217).

Thus, the record establishes that Stott knew, at the least, that contrary to plaintiff's explicit instructions, transactions for his account were being conducted at brokerage firms other than BEDCO. Further, defendant knew that such transactions involved low quality, speculative stocks whose purchase would not be permitted at BEDCO. Despite this fact, Stott assured plaintiff that he did not "have anything to worry about." (JA-217).

2. *Stott Knew That Yamada Was Purchasing Junk.*

Defendants' contention that Stott had "no reason to use the work 'junk'" ignores the Yamada purchases and their percentage of the overall portfolio. A mere glance at the portfolio reveals that Stott had ample reason to use the word "junk". Only Benguet Consolidated was a listed security.

Moreover, Stott was informed, in effect that the stocks were "junk". Yamada testified that he purchased various stocks, many of which, he informed Stott, were speculative in nature (JA-401), controlled (JA-399) and could not be purchased at BEDCO (JA-402, 403, 404, 405). Stott, himself, testified that he "laughed" about Hair Extension

Centers (JA-687), but claimed he did not question Yamada about the stock. Yamada testified that Stott in fact, did:

"Q. Do you recall what you told him about Hair Extension Centers?

"A. Yes, sir. He asked me about Hair Extension Centers, because of the peculiar name, and I told him we had a box on the stock and Rolf was not going to get hurt on it.

"Q. What did Mr. Stott say?

"A. Fine." (JA-399)

Yamada testified that Stott continually complained that "he wasn't getting enough commission business" (JA-406) Yamada stated that Stott had asserted that because of the poor quality of some of the stocks purchased by Yamada, Stott "felt he had a relationship with Rolf by then and that he could have that account pulled from me if I didn't further cooperate." (JA-407). Yamada testified:

"Q. Can you recall the exact word that he used when he described the securities that were in the account?

"A. Junk.

"Q. Was that the word he used?

"A. Some of the securities were junk.

"Q. Is it your testimony that he told you that unless he got more commission business he was going to tell Dr. Rolf about the junk?

"A. Yes, sir." (JA-408).

Thus, the record is replete with evidence that Stott knew that Yamada was purchasing for plaintiff stocks characterized by the trial court as "high-fliers" and "junk." The court properly concluded "that Stott did indeed, consider many of the securities to be 'junk' and that he told

this to Yamada," although not to plaintiff. (JA-43) Thus, the record reflects that in order to secure continued commissions, Stott exploited the confidence placed in him by plaintiff, concealing the fact that unsuitable securities were being purchased for him.

3. *Stott and Yamada Were In Daily Contact Concerning Yamada's Activities*

Although Stott contended throughout that his only function with respect to Dr. Rolf's account was to function as an order-taker, the record establishes that he and Yamada were in constant communication. Yamada testified that he and Stott were in daily contact. At one point, he recalled, they had a direct line between their offices. Yamada and Stott spoke "at least 10, 15 times a day." (JA-546). The conversations covered many aspects of the management of the plaintiff's account.

Defendant Stott admitted at the trial, that he or his secretary, spoke to Yamada on the telephone every day, sometimes more than once (JA-659, 660). At his deposition, however, Stott had denied such frequent contact with Yamada, contending that he had spoken to him a total of only twenty or thirty times:

"Q. In 1969, how many times did you see him—and that refers to Mr. Yamada.

"A. Well, you said phone to—oh, personally I saw him maybe six times on the phone. Oh, gosh, I don't know. Gee, it's going to be a little bit of a guess. I don't remember. Maybe 20 or 30 times.

"Q. That would be in the year 1969?

"A. I would say totally." (JA-660).

At the trial, Stott admitted that his deposition testimony was "obviously wrong." Stott also conceded at the trial, that although he spoke to Yamada daily, sometimes

more than once a day he had nevertheless told plaintiff that "he didn't work closely with Aki." (JA-661).

Thus, the record establishes that Stott and Yamada, during the relevant period, had a close, daily contact, including at one point a direct line, and the evidence of their constant dialogue renders Stott's claim of ignorance of Yamada's wrongdoing incredible. In addition, Stott's false denial of this contact on more than one occasion permits, plaintiff contends, the inference of guilty knowledge.

4. *Yamada's Assertions To Stott of Control Raised The Specter Of Wrongdoing Which Stott Ignored*

Although both Yamada and Stott asserted, and the trial court found, that Yamada had never told Stott of manipulations, Yamada testified that on numerous occasions he told Stott that stocks purchased for plaintiff were controlled. Thus, for example, Yamada testified that he did not discuss the investment merits of M. H. Studios, purchased for plaintiff, with Stott. However, when Stott questioned him, Yamada told him there was no cause for worry:

"Q. Prior to the time that you directed the acquisition of M. H. Studios for Dr. Rolf, did you discuss M. H. Studios with Mr. Stott?

"A. I did not discuss with Mr. Stott the investment merits of M. H. Studios, no, sir.

"Q. Did you have discussions with Mr. Stott—

"A. I recall he asked me what I was doing buying that stock and I told him there was a box on it, and don't worry, there would be a profit." (JA-463).

Yamada explained the meaning of the term "box" as used by him:

"Q. You have used the term 'box.'

"A. Yes, sir.

"Q. It is a term that at least to me is totally unknown. Could you explain to me, when you use the term 'box' what you mean by that term?

"A. In over-the-counter securities of, well, new issues, etc., where there are limited numbers of shares available in the hands of the public, usually 50, 60,000 shares or 100,000 shares, many times, in many cases an underwriter would make attempt to control all the publicly-held shares and if he is successful in controlling as many of the publicly-held shares as are outstanding, then he can move the stock up or down at his pleasure. When he has this control, the control is what I mean by 'box.'

"Q. Do I interpret you correctly to say that where you refer to the term 'box' you refer to a situation in which someone has cornered the market of the publicly available shares?

"A. Yes, a significant amount of the publicly issued shares." (JA-464).

Although Yamada never told Stott that M. H. Studios was "manipulated" or that there was any "cornering of the market," he testified that he "told him not to worry about it," that no money would be lost (JA-470).

Shares of GPI Enterprises were purchased for plaintiff, a purchase which Yamada also discussed with Stott. Again, although Yamada did not admit manipulation, such an inference could be easily drawn:

"Q. Prior to that point at which you placed that order with Woodcock for the purchase of GPI, what did you tell Mr. Stott respecting GPI?

"A. I told Mr. Stott that this was going to be a hot underwriting, that I knew the underwriter, that we had very definitely in this case control over it and it would open substantially higher and it was important

Rolf get an interest in this and I wanted to see Stott get the commission for this.

"Q. Did you use the term 'box' in defining the situation to Mr. Stott?

"A. I don't know if I did or not, but I made it very clear to Mr. Stott in this case that we had control of the stock, of the situation.

"Q. With respect to the control you spoke of, what is it that you told him was the control that you had?

"A. That it was obviously a very thinly traded stock, that there was only going to be 60,000 shares in the hands of the public and that the public that held the 60,000 shares would be friendly to management and to the underwriter and that the stock was going much, much higher. Here again I did not come out and tell Mr. Stott that the stock is going to be manipulated much higher, but I believe I reflected to him the fact that GPI Enterprises stock was going to be substantially higher." (JA-477-478).

With respect to the purchase for plaintiff of Hair Extension, Yamada "did not tell [Stott] there was a manipulation" (JA-484), but did discuss with him "the fact that the stock was going higher and don't worry about it, *there would be no problem.*" (emphasis added) (JA-485).

When Yamada purchased Health Evaluation with Stott, "[he] told him not to worry about it, the stock was going to go much higher, I knew people working in the stock." Yamada did not use the word manipulation, stating:

"Again, you know, you just didn't tell somebody 'I know there is a manipulation taking place and we can benefit by the manipulation.' You didn't have to tell somebody who was in the street that, you know. You didn't tell him, you just didn't do that. What I did say was that the stock would go higher, that it was

under control. . . . I alluded to the fact that factors other than basic investment values would cause those stocks to go up. If and when I said that about other stocks, I felt strongly that the fundamentals may carry itself, but there was very definitely an allusion on my part to Stott in the case of Hair Extension and Health Evaluation that the value was not in any fundamental investment sense, but there were other reasons why the stock would go up." (JA-490-491).

At no point does the record reflect that Stott questioned Yamada about his assurances that "the plaintiff wouldn't lose money." The Trial Court asked:

"THE COURT: Unless you have some remarkable powers, Mr. Stott may have wanted an explanation as to why you felt that that was so, that money would not be lost in it by the plaintiff. Did he inquire?" (JA-471).

Yamada's answer was not entirely responsive, but indicates that had Stott asked, he would have been told that "the situation is under control, he wouldn't lose money." (JA-471).

The record indicates that Stott's denial of wrongful knowledge was made in spite of circumstances which should have apprised him of the unlawful nature of the transactions in which plaintiff's money was being invested. At the least, they should have clearly alerted him to the fact that something might well be very amiss. However, despite the fact that plaintiff's money was being continually invested in obscure "junk," which was deemed under "control," Stott made no effort to investigate further. Plaintiff submits that if, as the Trial Court found, in aiding Yamada, Stott did not know of the illegal nature of the activities for which plaintiff's account was being used, "the only reason he did not learn it was because he deliberately chose

not to learn." Thus, Stott "had the full equivalent of knowledge" and his "self-imposed ignorance" cannot protect him from liability.* Conscious avoidance of the truth does not allow an individual to circumvent liability which would otherwise accrue.

Thus, even though knowledge is often difficult to prove by direct evidence, the record in this case is replete with direct evidence of Stott's actual knowledge that Yamada was betraying his trust. In addition, the record contains clear evidence that at the least, Stott, despite his responsibility to supervise plaintiff's account, deliberately closed his eyes to Yamada's gross fraud.

C. The "Hand-Holding" Operation of Stott Involved Both Misrepresentation And Recklessness And Is Actionable

The evidence concerning the "hand-holding" operation, during which Stott constantly misrepresented his actions and those of Yamada to plaintiff, is copious and, contrary to defendant's assertions, is quite precise "as to time and circumstances." Because the evidence on this point is so overwhelming, in addressing it, defendants again adopt their familiar tactic of ignoring the facts. Given defendants' heading, one might have expected a discussion of the evidence concerning Stott's role in the hand-holding operation and a refutation of the testimony of plaintiff and Yamada. However, rather than deal with the evidence concerning Stott's hand-holding conduct, defendants instead, launch into an irrelevant discussion of Dr. Rolf, proving in the process only that he was successfully duped by Stott and Yamada. Defendants, in apparent realization that the record provides no way to refute the testimony concerning Stott's role, attempt to create a smoke screen by a pointless discussion which sheds no light on the topic purportedly addressed.

* *United States v. Olivares-Vega*, 495 F. 2d 827, 830 n.10 (2d Cir.), *cert. denied*, 419 U.S. 1020 (1974).

Stott's "hand-holding" operation is not an incidental issue in this action, but a central one. It was not merely a few assurances that everything was "okay," but the establishment by Stott of a relationship of trust with plaintiff, which was exploited by defendants so that they might ransack his portfolio for their own ends. Stott's actions in this fraud and the relationship he established with plaintiff, go far toward answering the fundamental question raised by the Trial Court as to why plaintiff did not take his account away from Stott and Yamada.

To understand the role played by Stott, one must first look at the actions of plaintiff. During the time Stirling managed his account, plaintiff kept careful track of his securities, as noted by the Trial Court. Even though he was satisfied with Stirling's performance and trusted him implicitly, plaintiff still checked the prices of his securities every day and kept a bookkeeper to calculate the value of his portfolio. This does not evidence any investment expertise, since plaintiff could follow his portfolio in the newspaper and the calculations he made were mechanical in nature. Rather, it illustrates plaintiff's concern: he wanted to know how his portfolio was doing. It is only natural that this was important to plaintiff; the portfolio represented his life savings. During the period when his account was managed by Stirling, plaintiff was able to monitor the progress of his account since all of his securities were listed.

When Stott and Yamada took over Dr. Rolf's account, the situation changed radically. Plaintiff found it difficult to follow the transactions made in his account. Securities with which plaintiff was "somewhat familiar" (JA-108) were sold and "obscure" (JA-111) securities were purchased in their place, securities plaintiff "had never heard of." Accounts were opened at brokerage houses he "had never heard of" and new types of securities were purchased, "founders stock and new issues." Plaintiff had "never heard these terms before." (JA-186) As he testified, "I never heard of restricted, lettered stock." (JA-209).

It is quite clear that plaintiff was heading in a new, unknown direction, one that he had difficulty understanding. Putting him in that direction was Yamada, an unknown quantity. As plaintiff testified, "I heard of Tobell and Mr. Sterling, but I never heard of Mr. Yamada before." (JA-217). Faced with these new circumstances, plaintiff needed a man in New York whom he could "really trust." It is not surprising that he turned in his new environment to the one familiar entity, BEDCO and its representative, Michael Stott. Despite the fact that plaintiff was apprehensive about his new investments, as long as Stott and BEDCO were supervising his account, he felt secure.

The record is replete with evidence that plaintiff, looking to Stott and BEDCO for guidance, constantly made inquiry and complaint about certain of the securities purchased for his account, and that Stott always assured plaintiff that Stott and Yamada knew what they were doing. Stott's assurances were the same, whether questioned about specific transactions or the management of the account in general. Plaintiff testified that he complained about investments made on his behalf "many times, because the character and quality of securities just changed in such a striking fashion and there were many discussions about it." Plaintiff stated that he complained to "both" Stott and Yamada (JA-225). In response to his complaints, plaintiff received from Stott strong reassurance as reflected in the following examples:

"Q. When did those discussions take place?

"A. In that period when Mr. Yamada recommended Delanair, and he said—he indicated the investment would be about \$400,000, and I thought that was quite a bit of money, so I called Mr. Stott, and I said, 'Mike, what is this? This is a lot of money for me in this one security.'

And Mike said, 'Well, I think if Yamada said it was all right, it's all right. You can go ahead with it.'"
(JA-96)

* * *

"Q. Prior to your buying stock in Delanair and calls in Delanair, Mr. Yamada explained to you that stock, didn't he, told you you were buying private stock?

"A. Yes.

"Q. Did you discuss that with Mr. Stott?

"A. Yes, prior to the purchase, yes.

"Q. You had discussed it with Mr. Stott?

"A. Yes.

"Q. To your recollection, did Mr. Stott give you any advice with respect to your purchase of Delanair?

"A. I asked him whether I ought to go into that type—I never heard of restricted, lettered stock. He said, 'If Yamada thinks it is okay, you can go ahead with it.'"
(JA-209).

* * *

"Q. When you received confirmations for stocks you had never heard of, did you discuss them with Mr. Stott on any occasion?

"A. Yes.

"Q. On how many occasions?

"A. I can't give you the exact number, but there were frequent discussions.

"Q. To your recollection, what did Mr. Stott say on these occasions?

"A. In general, he said that Mr. Yamada knew what he was doing, that he was an excellent financial manager and that I was going to come out all right.

"Q. Did Mr. Stott, to your recollection, ever advise you not to go through with a trade that Mr. Yamada recommended?

"A. No." (JA-210).

* * *

"A. At that time I had enormous losses in Monarch Industries and Yamada proposed to take—as a matter of fact, to use exact figures, the loss was from 240,000 down to 70,000. There was a \$70,000 equity and Yamada said, 'I will restore your equity, I will put this in a hedge fund, Seljo [sic], and I have my father in it, my mother in it, my brother in it,' and at that time I was worried and I said to Mr. Stott, 'What do you think, should I go ahead with this' and he said, 'Oh, yes, if he has his family in there, you know, he is a bright guy and he will do all right.' " (JA-220).

* * *

"Q. Yes. Then you said after proceeds were invested you complained to Mr. Stott. When did you complain for the first time?

"A. I can't give you an exact date, but soon afterwards because I was very perturbed about the kind of securities we were getting, Hair Extension, Mental Tranquillaire, and these were not the kind of securities Mr. Sterling had and from that point on there were just many complaints.

"Q. Do you recall what Mr. Stott said to you?

"A. On most of these occasions Mr. Stott said that Mr. Yamada was a superb financial manager, he knew what he was doing, that he would restore my equity, I had nothing to worry about. He gave me an example of one man who had losses similar to mine and he said 'He got his money back,' and I said, 'How did he do it?' And he said Mr. Yamada controlled a lot of mutual

funds and he took these securities and placed them in the mutual funds and that this man came out fine, and I had the impression he would do the same for me.

“Q. Did you ever discuss with Mr. Stott the restoration of losses in your account?

“A. Oh, yes, many times.

“Q. What, to the best of your recollection, did you say about those losses and what did Mr. Stott say?

“A. I remember one occasion when I said, ‘Mike, this operation doesn’t make any sense. I don’t know what is going on, but it doesn’t make any sense,’ and he always said, ‘Look, you know what Yamada told you, no client of his has lost a dime,’ and Yamada told me that, too, ‘No client of mine has ever lost a dime.’” (JA-227-228).

* * *

“THE WITNESS: It involved a great deal of money and before I committed that much I asked Mr. Stott whether I should go ahead with it and he said yes, if Mr. Yamada thought it was all right, it was okay to go ahead.” (JA-232).

Yamada confirmed plaintiff’s testimony, and revealed Stott’s motive for his “intermediary” (JA-408) role:

“Q. What did [plaintiff] tell you about the stocks? Did he complain about them?

“A. He complained about them because he had never heard of them and he thought they were highly speculative.

“Q. Did you have a procedure for handling Dr. Rolf’s complaints when he called you to complain about the quality of the stocks?

“A. Well, in the latter stages of my handling Dr. Rolf’s account, whenever Dr. Rolf called me, I would

subsequently call Mr. Stott and have Mr. Stott call Dr. Rolf to hold his hand." (JA-409).

* * *

"Q. Do you have any personal knowledge as to whether the facts stated in the second paragraph of Exhibit E are true or false?

"A. I would say that they are absolutely false.

"Q. What is the basis for your saying they are false?

"A. Because a significant amount of the portfolio that Dr. Rolf had come through recommendations of Michael Stott and that he was in fact far from an order-taker. He helped me maintain the account, he helped hold Dr. Rolf's hand for me." (JA-412-413).

* * *

"Q. What do you mean by the statement 'That includes discussions with Mr. Stott?'

"A. I had discussions with Mr. Stott through this period regarding Dr. Rolf. I asked Mr. Stott on a number of occasions to call Dr. Rolf on my behalf, to, I guess use the term, hold his hand, to appease him. We had discussions on several occasions regarding telephone calls that Mr. Stott received from Dr. Rolf, where Dr. Rolf expressed his dissatisfaction. That is in essence what I am talking about." (JA-531-532)

Thus, the record establishes that in answer to plaintiff's expressed anxiety, Stott continually assured plaintiff he had no cause for concern. Stott's assurance never wavered, despite the fact that the "complexion of the account changed" and it pursued "a straight downhill course." (JA-237). In the face of an over-all pattern of heavy trading, in and out trades, sale of blue chips, the purchase of obscure "junk" securities, the "lock-up" of substantial funds and a steady decline in the portfolio value, Stott led plaintiff to believe that his investments were secure.

The evidence also demonstrates that Stott had no ground, whatsoever, for his continued expression of confidence in the management of plaintiff's account, having made not even a minimal attempt to ascertain the investment merits of the stocks involved, many of which he knew were of highly inferior quality. Further, promises of "control" constituted a covert suggestion of illegal activity which Stott ignored.

Not only the record, but applicable law, supports the trial court's finding of misrepresentation and recklessness. In *Wasson v. Securities and Exchange Commission*,* the Court held that a broker had aided and abetted a violation of the statutory prohibition against the sale of unregistered securities. Rejecting the defendant's claim of mere negligence, the court stated:

"In negligence law, the words 'willful,' 'wanton,' and 'reckless' are employed either singly or in combination to characterize conduct * * * more heinous or culpable than ordinary negligence." 57 Am. Jur. 2nd, Negligence, § 101 at 451; Prosser, Law of Torts, 184 (4th Ed. 1971). In several securities cases prosecuted under the willfulness standard of § 15, violations were found where the defendant proceeded in apparent disregard of or with reckless indifference to a known obligation or set of facts. In *Nees v. SEC*, 414 F. 2d 211 (9th Cir. 1969), a salesman was sanctioned for selling unregistered securities; he defended on the ground that he had no obligation to investigate the validity of his employer's claim of exemption. The Court found a willful violation on the ground that the defendant was aware of facts which should have caused him to question the exemption claim. Similarly, in *Stead v. SEC*, 444 F. 2d 713 (10th Cir. 1971), cert. denied, 404 U.S. 1059, 92 S. Ct. 739, 30 L. Ed. 2d 746 (1972), the Court upheld a willfulness finding where

* 558 F. 2d 879 (8th Cir. 1977).

the defendant consciously closed his eyes to suspicious facts which should have suggested the need for registration.

"In our judgment, Wasson's conduct fits squarely within the holdings of those cases and the meaning commonly given to the willful or reckless standard. He was aware of several facts suggesting the suspicious nature of the transaction. With reckless indifference to those facts, he proceeded to facilitate the sale, ignoring the obvious need for further inquiry and his duty to disclose all relevant information to his superiors. Our construction of the term willful, in accordance with those of the other Circuits, allows no other interpretation of Wasson's behavior." at. 887.

This Court has held that a broker cannot make representations with respect to a security unless there is "an adequate or reasonable basis" therefor. "He must disclose facts which he knows and those which are reasonably ascertainable. . . . Where the salesman lacks essential information about a security, he should disclose this as well as the risks which arise from his lack of information."* All of this, Stott failed to do.

Defendants erroneously contend that plaintiff's failure to complain about the purchase of securities at the time of the purchase allows defendants to escape liability. As the Trial Court found, plaintiff, having confidence in the defendants who handled his portfolio, relied upon their express representation that such purchases were sound ones, made in his best interest. Having sought to mollify plaintiff by deceit, defendants cannot now complain that plaintiff was deceived.

The cases cited by defendants do not support their contentions and are not applicable to the facts of this case.

* *Hanly v. Securities and Exchange Commission*, 415 F. 2d 589 (2d Cir. 1969).

In *Ocrant v. Dean Witter & Co.*,* plaintiff sought to recover for the unauthorized sale of stock about which she made no complaint. The court held that since plaintiff did not make a timely complaint of the allegedly unauthorized sale, thereby permitting any mistake to be rectified, she was barred from recovery. In *Ocrant*, the confirmations and monthly statements provided the plaintiff with full and complete knowledge of the alleged mistake. In this case, however, the confirmations and monthly statements received by the doctor did not provide him with knowledge that his account was being used to support the price of manipulated securities and that purchases and sales were being made for the purpose of generating brokerage commissions. Unlike *Ocrant*, plaintiff's claim is not based upon a "mistake," but upon a charge of fraud and deceit.

In *Landry v. Hemphill Noyes & Co.*,** the plaintiff's consent was obtained in advance of each trade, as his account was a non-discretionary one. The court concluded that since plaintiff approved in advance each of the frequent transactions made in his account, plaintiff's account should be regarded as a trading account. The court then considered the evidence as to whether plaintiff had offered sufficient proof to establish that a trading account had been churned and found the evidence deficient. Unlike that account involved in *Landry*, the plaintiff's account was a discretionary one and he did not approve of trades in advance.

In *Ferguson v. Francis I. du Pont & Co.*,*** the plaintiff, an attorney and experienced investor, contended that stock was repeatedly purchased for his account without his authority. The plaintiff's failure to make prompt complaint of the alleged mistakes being made in his account barred him from recovery. Again, the claim in *Ferguson* did not involve fraud or a lack of knowledge on the part of the

* 502 F. 2d 854 (10th Cir. 1974).

** 473 F. 2d 365 (1st Cir.) *cert. denied*, 414 U.S. 1002 (1973).

*** 369 F. Supp. 1099 (N.D. Tex. 1974).

plaintiff concerning the improper transactions. The plaintiff in *Ferguson* knew or should have known immediately that, without his authority, purchases were being made for his account, if in fact such purchases were being made.

In *Hecht v. Harris Upham & Co.*,* the plaintiff's account was actively traded, without complaint, for almost seven years. Plaintiff sought recovery based upon the difference in value between her account if no trading had taken place over the seven years and the value of her account after the seven years of trading. Plaintiff was barred from recovery on the theory asserted on the ground that her failure to complain about the active trading in her account for almost seven years constituted acquiescence in such activity. However, the plaintiff was allowed to recover for churning since the confirmations and monthly statements were inadequate to put plaintiff on notice that excessive trading had occurred in her account.**

In affirming on appeal, the Court of Appeals in advance set forth the following elements which are required to support the defense of estoppel:

"Four elements must be present to establish the defense of estoppel: (1) The party to be estopped must know the facts; (2) he must intend that his conduct shall be acted on or must so act that the party asserting the estoppel has a right to believe it is so intended; (3) the latter must be ignorant of the true facts; and (4) he must rely on the former's conduct to his injury."

The absence of any one element is sufficient to prevent an estoppel from being established. In Dr. Rolf's case, all four elements are missing. Dr. Rolf did not know the facts; he did not intend to mislead the defendants; the defendants

* 283 F. Supp. 417 (N.D. Cal. 1968) *aff'd*, 430 F. 2d 1202 (9th Cir. 1970).

** Plaintiff's securities account appreciated in value during the seven years in which it was actively traded. Accordingly, the defendants' liability was limited to commissions earned on the account.

had knowledge of the true facts, and the defendants did not rely upon the doctor's conduct to their injury. The assertion by defendants that the doctor is estopped by his failure to make prompt complaint upon each transaction is a completely specious defense, unsupported by the facts and the law.

Further, the record indicates that although the plaintiff failed to make complaint about certain individual transactions, he did, indeed, complain about the pattern of trading when it became evident to him. Thus, the doctor complained of the shift from high grade securities to lowest of the low. Far from demonstrating a lack of complaint on the part of Dr. Rolf, the record reveals that both Yamada and Stott were acutely alert to the doctor's dissatisfaction and took active steps to mollify him in order to continue their own wrongdoing.

POINT VIII

The Record and Applicable Law Fully Support the Finding of Liability of Stott and BEDCO for Violations of N.Y.S.E. and N.A.S.D. Rules.

A. The Rules Are Actionable

Rules of the New York Stock Exchange require that member firms establish, maintain and diligently enforce a system of internal suspension and control. The New York Stock Exchange, itself, has recognized that "[t]he ultimate responsibility for proper supervision and control rests with top management of each member firm."^{*}

Liability of a brokerage firm may be predicated upon failure properly to supervise a customer's account. It is now established that a private right of action may be main-

^{*} New York Stock Exchange, *Supervision and Management of Representatives and Customer Accounts*, (1973) 2, 3.

tained against a party other than an exchange for violation of certain exchange rules. *Buttrey v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*,* In the *Buttrey* case, a violation of NYSE Rule 405 was held to be actionable, and in reaching its decision the court applied the standard set forth in *Colonial Realty Corporation v. Bache & Co.*,** the first case to deal directly with the issue. In that case, Judge Friendly made clear that some exchange rules might "provide the basis for implying a private right of action" and outlined a mode of analysis for making that determination:

"What emerges is that whether the courts are to imply federal civil liability for violation of exchange or dealer association rules by a member cannot be determined on the simplistic all or nothing basis urged by the two parties; rather the court must look to the nature of the particular role and its place in the regulatory scheme, with the party urging the implication of a federal liability carrying a considerably heavier burden of persuasion than when the violation is of the statute or an SEC regulation. The case for implication would be strongest when the rule imposes an explicit duty unknown to the common law." 358 F. 2d at 182.

The court postulated that a stock exchange rule which amounted to "a substitute for regulation by the SEC itself" could form the basis of a federal cause of action. *loc. cit.*

The court recognized that some rules impose only house-keeping duties which do not warrant federal enforcement,

* 410 F. 2d 135 (7th Cir.) cert. denied, 396 U.S. 838 (1969). In *Stevens v. Abbott, Proctor & Paine*, 288 F. Supp. 836 (E. D. Va. 1968), the court also sustained a private right of action for failure to supervise the plaintiff's account "as required by Rule 405 of the New York Stock Exchange."

** 358 F. 2d 178 (2d Cir. 1966).

but asserted that rules which could "play an integral part in SEC regulation" could support a federal cause of action. The court in *Buttrey, supra*, adopted the *Colonial* standard and held that the violation of a stock exchange rule was actionable where it "was designed for the protection of investors" and "plays an integral part in SEC regulation." (410 F. 2d at p. 142). The Seventh Circuit further held that a rule designed for the protection of investors was presumably actionable and that the allegation of a violation thereof could survive a motion to dismiss.

Rule 405, itself, supports the holding in *Buttrey*, since the Rule was designed to combat fraud. The Rule provides in pertinent part:

"Every member organization is required through a general partner, a principal executive officer or a person or persons designated under the provisions of Rule 342(b)(1) to

(1) Use due diligence to learn the essential facts relative to every customer, every order, every cash or margin account accepted or carried by such organization and every person holding power of attorney over any account accepted or carried by such organization.

(2) Supervise diligently all accounts handled by registered representatives of the organization."

Compliance with Rule 405 requires managers "to examine accounts for *questionable* patterns of trading such as:

1. Evidence of excessive trading.
2. Consistent in and out trading.
3. ***
4. Speculative activity.
5. Concentration in any one security.
6. Low grade securities.
7. ***

* New York Stock Exchange, *Supervision and Management of Registered Representatives and Customer Accounts.* at 2, 3.

Thus, Rule 405 and its implementation by the New York Stock Exchange demonstrate that it was designed to combat fraud. Accordingly, plaintiff submits, Rule 405 comes within the standard enunciated in *Colonial Realty*.

There have been divergent judicial views as to whether Rule 405 gives rise to an implied right of action. Defendants cite authority for the proposition that it does not. The court below cited in support of its conclusion, *Starkman v. Seroussi*,* a decision which plaintiff contends, constitutes the better view.** This court has not, as defendants suggest, repudiated the *Starkman* holding. In *Van Gemert v. Boeing Co.*,*** the court stated:

"Nevertheless, we do not now take the position that appellees advance and the court below apparently accepted, that violation of an exchange rule cannot under any circumstances give rise to civil liability under the federal acts. Such a position would be in conflict with our own most recent statements on this subject as well as some of the developing case law. See, e.g., Judge Weinfeld's opinion in *Starkman v. Seroussi*, 377 F. Supp. 518 (S.D.N.Y. 1974) (conduct in violation of Rule 345.17 of the Exchange prohibiting registered representatives from guaranteeing any customer against loss in his account or receiving a share in the profits or sharing in the losses of a customer's account, held actionable); *SEC v. First Securities Co. of Chicago*, 463 F. 2d 981 (7th Cir.), cert. denied, *McKy v. Hochfelder*, 409 U.S. 880, 93 S. Ct. 85, 34 L. Ed. 2d 134 (1972) (violation of NASD rule protecting public gives rise to private damage action). Cf. *Landy v. Federal Deposit Insurance Corp.*, 486 F. 2d 139, 164-66 (3d Cir. 1973), cert. denied, 416 U.S. 960, 94 S. Ct. 1979, 40 L. Ed. 2d 312 (1974)." at 1381.

* 377 F. Supp. 518 (S.D.N.Y. 1974).

** See also, *Geyer v. Paine, Webber, Jackson & Curtis, Inc.*, 389 F. Supp. 678 (D. Wyo. 1975).

*** 520 F. 2d 1373 (2d Cir. 1975).

The rules of the NASD were enacted pursuant to section 15A of the Exchange Act. Section 27 of such rules requires each member to investigate and supervise the activities of its registered representatives and associated persons, including correspondence and customer accounts. A violation of Section 27 has been held to "provide a basis for private damage actions,"* and plaintiff contends that such a violation has occurred in this case.

B. The Defendants Violated NYSE And NASD Rules

The record clearly establishes the defendants Stott and BEDCO's culpable failure to adhere to the requirements of the NYSE and NASD Rules. As fully discussed above, Stott not only failed to supervise the plaintiff's account, but actively participated in its looting. BEDCO also failed to protect the plaintiff. Despite the fact that the BEDCO compliance department possessed a computed programed to "kick out" any account whose monthly statement revealed more than ten trades or \$250 in commissions (JA-878), in the case of the plaintiff, his account was ignored. The monthly statements for the Rolf account in 1969, reveal that for each of the first seven months the account was in the hands of Stott and Yamada, and for eight of the first nine months, the commissions generated in the account were sufficient to cause it to be "kicked out:"

	<u>Net Commissions</u>	<u>Gross Commissions</u>	
5/69	2,644	7,932	(DX, Q-3-Q-11)
6/69	1,459	4,377	(DX, Q-11-Q-19)
7/69	2,583	7,750	(DX, Q-20-Q-37)
8/69	2,204	6,611	(DX, Q-37-Q-50)
9/69	483	1,450	(DX, Q-50-Q-53)
10/69	639	1,918	(DX, Q-54-Q-61)
11/69	437	1,311	(DX, Q-62-Q-66)
12/69	110	330	(DX, Q-71)
1/70	1,061	3,183	(DX, Q-68-Q-70, Q-70, Q-72-Q-80)

* *Securities and Exchange Commission v. First Securities Co. of Chicago*, 463 F. 2d 981, 988 (7th Cir. 1972), cert. denied 409 U.S. 880. (1972)

No inquiry was made although clearly, by BEDCO's own standards, investigation was called for. The compliance department of eighteen men and computers, which reviewed every transaction made in the firm, ignored Dr. Rolf's account as it was being gutted in plain view. (JA-877) Thus, BEDCO closed its eyes to any possible collusion between Stott and the investment adviser he had recommended (JA-877, 904-905, 922-924).

A slight inquiry would not only have revealed that Stott had referred Dr. Rolf to Yamada, but also that Stott was making recommendations in the doctor's account. Although evidence of churning and unsuitable investments appeared every month, BEDCO chose to ignore it. Thus, it failed to discover that in the first seven months after assignment of the Rolf account to Stott, contrary to the policy of the firm, he had been trading in low quality stocks, and concomitantly, the doctor's liquid assets in BEDCO's custody had been reduced over one million dollars. During the entire period, BEDCO's compliance department closed its many eyes, and like Argus of Ovid, saw only "one darkness."* The trial court properly held that the actions of BEDCO "operated as fraud upon Dr. Rolf" (JA-64).**

C. Where the Broker and Investment Adviser Work in Concert, Both Are Liable For Violations Of The Securities Laws

The court below held "that the broker, by virtue of his position, owes a fiduciary duty to his customers." (JA-49). The court cited ample and valid authority for that holding and its further conclusion that the trading authorization executed by plaintiff did not immunize defendants BEDCO and Stott from liability nor relieve them of their fiduciary duties. Defendants cite no authority for their contrary

* Ovid, *Metamorphoses*.

** BEDCO was also properly held liable for the conduct of Stott on the basis of its status as a controlling person and principles of respondent superior.

contention, but allege instead, the difficulty of monitoring the actions of investment advisers which include those of various institutional investors.

Plaintiff submits that difficulty in protecting investors does not relieve defendants of the obligation of doing so. As in the case of a discretionary account, individual investors with advisers are in need of protection. Numerous safeguards, legislative and otherwise, have been set up for the protection of institutional investors,* pension funds,** insurance companies and others of a similar nature. However, individual investors seldom have "the requisite financial expertise to monitor the activities of their investment advisers" as do "financial advisers to institutions such as pensions and endowments."***

Accordingly, broker-dealers who refer customers to investment advisers routinely monitor their services in exchange for commissions. Indeed, "[a] number of firms whose principal line of business consists of evaluating performance and management services have come to be- ing."**** Thus, contrary to defendants' contention that monitoring duties would constitute an undue burden, they are routinely assumed by brokerage firms.*****

As one commentator has observed, the assumption of supervisory duties entails responsibility:

"Broker-dealers who receive compensation in any form for making referrals are not mere middlemen without

* Representatives of such investors have ready access to Stock Exchange information and officials and other assistance.

** See, e.g., the Employee Retirement Income Security Act of 1974, 29 U.S.C. §§ 1001-1381.

*** Bines, *Regulating Discretionary Management: Broker-Dealers As Catalysts For Reform* 16 B.C. Ind. & Com. L. Rev. 347, 360 n. 71 (1975).

**** *Ibid* at 376 n. 126.

***** Defendants also speciously suggest that since some financial experts have made mistakes, no attempt should be made to supervise the management of an account by an investment adviser.

any initial or continuing obligation to their clients. By virtue of the consideration they receive for making referrals, they should be held to be statutory investment advisers, and thus subject to the regulatory restrictions against self-dealing imposed by the Advisers Act. Thus, in addition to the regulatory protection of the Advisers Act provided investors with respect to their portfolio managers, investors will benefit by having another financially responsible party to answer for the breaches of duty of the adviser, at least if the referring broker-dealer was or should have been aware of the adviser's breach of duty. This factor not only enhances investor protection in cases of actual wrongdoing, but also encourages broker-dealers to watch over advisers to prevent wrongdoing."*

In the instant case, not only can a duty to plaintiff be imposed upon Stott as a matter of law by virtue of his professional status and relationship with both plaintiff and Yamada,** but in addition, by the fact that Stott specifically

* Bines, *op. cit.* at 377.

** "There are several theories under which a continuing duty to monitor and evaluate the adviser might be imposed on the broker-dealer. The adviser and broker-dealer might be regarded as joint venturers in managing the client's account, the adviser assuming principal responsibility for executions and custody of the portfolio. Or, by virtue of the broker-dealer's power to promote an advisory relationship between the client and the adviser, the broker-dealer might be regarded as the agent and the adviser as a sub-agent of the client.

[An agent is liable to his principal] if, having a duty to appoint or to supervise other agents, he has violated his duty through lack of care or otherwise in the appointment or supervision, and harm therefore results to the principal in a foreseeable manner. He is also subject to liability if he . . . permits, or otherwise takes part in the improper conduct of other agents.

Restatement (Second) of Agency § 405(2), at 251 (1958). The critical elements of these and other common-law theories of recovery are the position the broker-dealer occupies with respect to selection of an adviser and the compensation the broker-dealer receives for his efforts. To the extent a broker-dealer aids an investor in selecting an adviser the broker-dealer represents that he has the professional ability to choose an adviser offering competent advisory services. He owes

agreed to monitor for plaintiff, Yamada's investment decisions. Having voluntarily undertaken to do so in exchange for commissions to be earned by virtue of transactions in the account, Stott and BEDCO cannot, now, escape liability by claiming that the task was too onerous. Moreover, not only did Stott fail to supervise Yamada, but Stott aided Yamada's violations and wilfully misrepresented his management of the plaintiff's account. The Trial Court's conclusion that defendant Stott unlawfully violated his trust was clearly a correct one.

D. The Exchange Act Imposes High Standards Of Professional Responsibility Upon Brokers In Order To Protect Investors. Defendants Failed To Observe Such Standards

The securities laws were enacted as a response to the rampant speculation of the 1920's, the market crash of 1929, and the depression which followed. President Roosevelt in his message to Congress recommending the enactment of the Exchange Act, referred to the need to eliminate "unnecessary, unwise and destructive speculation."* An investigation of the causes of the market crash of 1929 had revealed that it was prevalent practice among broker-dealers and other professionals having custody and control over customers' money to use such power thus obtained to promote their own interests in total disregard of those of their customer.

It was, therefore, not surprising that when Congress directed its attention to the abuses revealed in the investiga-

the client a duty or ordinary skill and care in executing this responsibility. Moreover, the referral fee is consideration for assuming that duty. If the broker-dealer also receives continuing compensation during the life of the advisory agreement, the only reasonable explanation for such compensation is that it is in exchange for the assumption of continuing duties with respect to the account. Any other interpretation would allow the broker-dealer the right to profit on a regular basis from the advisory relationship without any corresponding duty to the client." *loc. cit.* n. 127.

* S. Rep. No. 792, 73d Cong., 2d Sess. 1-2 (1934).

tion, it enacted a law that imposed strict trust duties upon brokers.

"If investor confidence is to come back to the benefit of exchanges and corporations alike, the law must advance. As a complex society so diffuses and differentiates the financial interests of the ordinary citizen that he has to trust others and cannot personally watch the managers of all his interests as one horse trader watches another, it becomes a condition of the very stability of that society that its rules of law and of business practice recognize and protect that ordinary citizen's dependent position. Unless constant extension of the legal conception of a fiduciary relationship—a guarantee of straight shooting—supports the constant extension of mutual confidence which is the foundation of a maturing and complicated economic system, easy liquidity of the resources in which wealth is invested is a danger rather than a prop to the stability of that system. When everything everyone owns can be sold at once, there must be confidence not to sell. Just in proportion as it becomes more liquid and complicated, an economic system must become more moderate, more honest, and more justifiably self-trusting."*

The Congressional purpose of investor protection** which impelled enactment of the Exchange Act has been implemented in the anti-fraud provisions contained in that legislation and in the rules adopted by the SEC, the NYSE and the NASD. Such provisions and rules proscribe conduct of the very type engaged in by defendants Stott and BEDCO. It was contemplated that enforcement of those rules would prevent the recurrence of the abuses of the period whose repetition had "convinced a patient public that enlightened self-interest in private leadership is not

* H. R. Rep. No. 1383, 73d Cong., 2d Sess. 5 (1934).

** "It [Securities Exchange Act] certainly is designed to hamstring some kinds of business—the business of fleecing lambs particularly." From a *Washington Star* editorial as quoted in 78 Cong. Rec. 7921 (1934) (remarks of Representative Mapes).

sufficiently powerful to effect the necessary changes alone that private leadership seeking to make changes must be given government help and protection.”*

The period 1969-1971, like that existing at the time of the Exchange Act's enactment, was characterized by abrupt fluctuation in the price of securities and rampant speculation. John Cione testified:

“The successful market there was in '66, '67, '68 and it was a bullish market for the most part, created new service companies, computer-type companies, created an atmosphere where people went into business with no assets, with just an idea, with a cagey name, and they bought the issue public through an underwriter and underwriters were being created every day, new brokerage firms were being created as underwriters, venture capital firms and some of these stocks were just not going anywhere or some of them were quickly going up and then collapsing because they didn't have the management background or whatever the reason was, or money got a little tighter and as money got tighter, a lot of the operations which were high leverage didn't succeed, but that '69 period was an introductory period to just literally hundreds of names.

* * * * *

“Our offerings were not at the two to five dollar range. We were bringing companies out at 16, which some of them opened trading at 40, some of the stocks that were five, were opening at eight and ten.” (JA-963-964).

The legislative history instructs us that the existence of such circumstances calls for stringent enforcement of the Exchange Act and the rules and regulations promulgated thereunder. Thus, plaintiff contends, if the Exchange Act is to serve the purpose for which it was enacted, the conduct of defendants Stott and BEDCO should be condemned and plaintiff permitted to recover his losses.

* H. R. Rep. No. 1383 at 5.

CONCLUSION

The Trial Court correctly found all three defendants guilty of fraud upon the plaintiff. Defendants attempt to escape liability for the consequences of such fraud by the fragmentation of conduct which constituted a seamless web. However, the evidence establishes that the defendants are responsible for the plaintiff's losses and the Trial Court erred substantially in failing to compensate plaintiff for them.

The judgment below, insofar as it relates to damages, should be vacated and damages in the amount of plaintiff's net trading losses should be added to the damages already awarded. The judgment, insofar as it relates to the defendants' fraud, should be affirmed.

Dated: New York, New York
September 30, 1977

Respectfully submitted,

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Cross-Appellee

Against

Blyth Eastman Dillon & Co., Inc.
et. al.

DOCKET NO. 77-7104

Defendants
Appellees
Cross-Appellants

State of New York,
County of New York,
City of New York—ss.:

Anthony Torres, being duly sworn, deposes
and says that he is over the age of 18 years. That on the 30th
day of September, 1977, he served five true copies of
the within brief on
Breed Abbott & Morgan, the attorneys
for defendants-appellees- cross-appellants
by delivering to and leaving same with a proper person in charge of
their office at One Chase Manhattan Plaza
in the Borough of Manhattan, City of New York, between
the usual business hours of said day.

Anthony Torres
.....
Anthony Torres

Sworn to before me this

30th day of September, 1977

Antoinette M. Stallone

ANTOINETTE M. STALLONE
NOTARY PUBLIC, State of New York
No. 24-9150102
Qualified in Kings County
Certificate filed in New York County
Commission Expires March 30, 1978